Supreme Court, U.S.
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IN THE

Supreme Court of the United States

DAOU SYSTEMS, INC., GEORGES DAOU, DANIEL DAOU, FRED MCGEE, ROBERT MCNEILL AND JOHN MORAGNE,

Petitioners,

v.

GREG SPARLING, EUGENE KRABBENHOFT, PATRICK DE KRUYFF, ROBERT ZARETSKY, ROD FORD, THOMAS V. HAGMAN, RICHARD W. WALSH, RICHARD TORIBIO AND PAUL RABIN, ON BEHALF OF THEMSELVES AND ALL OTHERS SIMILARLY SITUATED,

Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

This case raises the following questions:

1. Whether a securities fraud plaintiff invoking the fraud-on-the-market theory can adequately allege loss causation, consistent with this Court's recent decision in *Dura Pharmaceuticals, Inc.* v. *Broudo*, simply by alleging a drop in a stock price without specifically alleging how or when the alleged "fraudulent acts" by the defendants ever became known to the market.

2. Whether, given the breadth of discovery in civil actions and the strict pleading requirements of the Private Securities Litigation Reform Act, a securities fraud plaintiff can adequately state a claim based on the alleged statements of "confidential" sources.

LIST OF PARTIES AND AFFILIATES

Petitioners, defendants/appellees/cross-appellants below, are Daou Systems, Inc., Georges Daou, Daniel Daou, Fred McGee, Robert McNeill and John Moragne. On October 28, 2005, Daou Systems, Inc. merged with PRX Acquisitions Sub, Inc. to form Proxicom-Daou, Inc. Proxicom-Daou, Inc. is wholly owned by Proxicom, Inc. There is no publicly held corporation that owns 10% or more of stock in Proxicom, Inc.

Respondents, plaintiffs/appellants/cross-appellees below, are Greg Sparling, Eugene Krabbenhoft, Patrick De Kruyff, Robert Zaretsky, Rod Ford, Thomas V. Hagman, Richard W. Walsh, Richard Toribio and Paul Rabin.

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Petitioners, Daou Systems, Inc., Georges Daou, Daniel Daou, Fred McGee, Robert McNeill and John Moragne ("Petitioners"), respectfully pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit in this case.

OPINIONS BELOW

The Order and Amended Opinion of the Ninth Circuit (App. 1-42) after the motion for rehearing is reported at 411 F.3d 1006 (9th Cir. 2005). The opinion of the district court is not reported, but is reprinted at Appendix 104-133.

JURISDICTION

The opinion of the Court of Appeals was issued on February 2, 2005. After the filing of a timely petition for rehearing, the Court of Appeals denied the petition and filed an Order and Amended Opinion on June 21, 2005. (App. 1-42.) Because the Ninth Circuit's Order and Amended Opinion conflict with this Court's decision in *Dura Pharmaceuticals, Inc.* v. *Broudo*, 125 S. Ct. 1627 (2005), a petition for rehearing *en banc* was timely filed on July 14, 2005. The Ninth Circuit denied the petition. (App. 139-140.) This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

STATUTES INVOLVED

The provisions of the Securities Exchange Act of 1934, 15 U.S.C. § 78a, et seq., relevant to this petition, including the Private Securities Litigation Reform Act of 1995 ("PSLRA"), Pub. L. No. 104-67, 109 Stat. 737, are reproduced at Appendix pages 141-143.

STATEMENT OF THE CASE

Despite this Court's recent decision in *Dura Pharmaceuticals, Inc.* v. *Broudo*, 125 S. Ct. 1627 (2005), the Ninth Circuit held in this case that the plaintiffs adequately pled the essential element of loss causation in this securities class action even though the complaint does not allege any point in time when the "share price fell significantly after the truth

became known," *id.* at 1634, and failed to connect any disclosures to any alleged misrepresentations by the defendants. In contrast to this Court's decision in *Dura* and how other Courts of Appeals have interpreted the loss causation requirement, the Ninth Circuit's approach to loss causation continues to "allow recovery where a misrepresentation leads to an inflated purchase price but nonetheless does not proximately cause any economic loss." *Dura*, 125 S. Ct. at 1633.

Moreover, despite the PSLRA's requirement that certain facts in a securities class action be pled with particularity, the Ninth Circuit held the complaint sufficiently stated a claim for securities fraud based largely on the alleged statements of confidential witnesses. The Ninth Circuit relied on these alleged statements without engaging in a thorough analysis of the potential reliability of these confidential witnesses, including whether they were even employed by the defendant at the time of the alleged acts or whether there was other indicia of personal knowledge to support their statements.

A. Factual Background.

Petitioner Daou Systems, Inc. ("Daou") "created, implemented, and supported computer networking systems for use in the healthcare field." (App. 45.)[1] The individual petition-

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[1] The facts set forth below are based on the Third Amended Complaint and accepted as true for the purposes of this petition, as the Ninth Circuit's decision reversed the district court's grant of Petitioners' motion to dismiss. The issues presented in this petition are squarely presented at this time and are ripe for review. As was pointed out by the petitioners in *Dura*, and as this Court no doubt recognized last term in granting the petition for a writ of certiorari in *Dura*, most securities cases settle before reaching a trial or other final disposition. *See* Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497 (1991) (discussing the higher settlement rate for securities class actions compared to civil actions generally). Thus, a denial of this petition increases the likelihood that the issue will not be resolved and suggests that the Court should not defer consideration until a later time. *See United States* v. *Gen. Motors Corp.*, 323 U.S. 373, 377 (1945); *Gillespie* v. *United States Steel Corp.*, 379 U.S. 148, 153 (1964).

ers were or are various officers and directors of Daou. Respondents are "a class of former Daou . . . investors who purchased Daou common stock between February 13, 1997 and October 28, 1998" (the "class period"). (App. 44.)

Respondents allege petitioners engaged in misrepresentations in connection with how Daou recognized revenue under a method of accounting known as Percentage of Completion ("POC"). In its public disclos res, Daou said "Revenues recognized in excess of amounts billed and project costs are classified as contract work in progress." As Respondents recognize, that is how Daou actually recognized revenue.

In each of its publicly reported documents, Daou disclosed its POC accounting methodology, including the fact that revenue recognition did not always correlate with billing. Typical of this disclosure is that alleged in Respondents' Third Amended Complaint ("TAC"):

> Contract revenue for the development and implementation of network solutions is recognized on the percentage-of-completion method with progress to completion measured by labor costs incurred to date compared to total estimated labor costs. Provisions for estimated losses on contracts, if any, are made during the period when the loss becomes probable and can be reasonably estimated. Revenues recognized in excess of amounts billed and project costs are classified as contract work in progress. Revenue from technical support and network management services is recognized over the period the services are performed. Payments received in advance of services performed are recorded as deferred revenue and amortized as the services are performed.
>
> . . .
>
> Certain contract payment terms may result in customer billing occurring at a pace slower than revenue recognition. The resulting revenue recognized

> in excess of amounts billed and project costs are classified as contract work in progress on the Company's balance sheet.

(TAC ¶¶ 24, 44.)

In August and October 1998, Daou's stock price fell after the disclosure of a discrepancy regarding certain merger expenses and the report of disappointing financial results for the third quarter of 1998. (TAC ¶¶ 78, 82.) This report was not a cleansing disclosure or a mea culpa with respect to Daou's employment of the POC method of accounting. In fact, it described Daou's continued use of the same accounting methodologies.

B. The Complaint And Procedural History.

Although Daou did not change the manner in which it recognized revenue, Respondents immediately filed suit in August 1998, alleging violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 (the "Exchange Act") and Sections 11, 12(a)(2) and 15 of the Securities Act of 1933 (the "Securities Act").[2]

The TAC is premised on the allegation that Daou's publicly reported revenues and associated statements to analysts between the first quarter of 1997 and the second quarter of 1998 were materially false. The primary reason why each of these statements were purportedly false when made is identical—Respondents claim that Daou violated Generally Accepted Accounting Principles ("GAAP") when it recognized revenue during this time period. (TAC ¶ 3.) While respondents concede that GAAP approves of the POC method of revenue recognition, they claim that Petitioners engaged in misrepresentations by applying it improperly. Since Respondents acknowledge that Daou fully disclosed its use of

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[2] The complaint went through several iterations, including a Second Amended Complaint that was dismissed, until the plaintiffs filed the Third Amended Complaint (TAC) that is at issue here.

the POC method of accounting, Respondents' claim of wrongdoing is reduced to Daou's failure to confess its misapplication. (*Id.*) More specifically, Respondents contend that Daou misapplied POC by recognizing revenue before it was earned. (TAC ¶¶ 33, 44(d).) Respondents also attempt to predicate liability on various statements made regarding the Company's pipeline and backlog, as well as employee hiring, retention and training. (TAC ¶¶ 71-77.) Virtually all of the factual allegations of the TAC are attributed to various "confidential witnesses," rather than alleged on personal knowledge.

Petitioners moved to dismiss on several grounds, including the fact that Respondents had failed to meet the pleading requirements of the PSLRA and, in particular, that they had failed to allege loss causation. The district court *agreed*, concluding that the accounting fraud allegations were insufficient, in that Respondents had failed to provide specific facts showing that Daou misled investors with regard to their accounting methodology. (App. 111-24.) The district court also found that the statements of confidential witnesses were hopelessly vague and conclusory and not based on personal knowledge. (App. 122.) Concluding that Respondents had failed sufficiently to allege any material misrepresentations, scienter, or loss causation, the court dismissed the action with prejudice. (App. 132.)

Respondents appealed,[3] and the Ninth Circuit reversed. (App. 43-82.) Petitioners filed a petition for panel rehearing, arguing among other issues that the TAC never alleged any date when "the truth became known" about the alleged misrepresentations, and thus could not meet the loss causation standard of any Circuit but the Ninth Circuit. The Ninth Circuit stayed the matter pending the outcome of this Court's

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[3] Daou cross-appealed on November 26, 2002, because the district court, upon issuing its order, failed to determine the propriety of sanctions against Respondents and their attorneys pursuant to the PSLRA.

decision on loss causation in *Dura*. After supplemental briefing following this Court's decision in *Dura*, the Ninth Circuit denied the petition for panel rehearing and issued an amended opinion. (App. 1-42.)

In the Amended Opinion, the Ninth Circuit held that loss causation was sufficiently pled based on its "independent assessment of the TAC." (App. 33.) The court found "that the price of Daou's stock fell precipitously after defendants began to reveal figures showing the company's true financial condition." (*Id.*) The court reached this conclusion based in part on allegations that in August 1998 "defendants revealed that Daou's operating expenses and margins were deteriorating and, on October 28, 1998, defendants revealed that Daou had dramatically missed its projected 3Q98 earnings and would have to report a loss of $0.17 a share." (App. 33 (quoting TAC).) The court also relied on the fact that "the TAC anonymously quotes an analyst who allegedly stated, '[w]hen you say one thing on the conference call and report something different on the 10-Q, that raises concern . . . . You have got to question whether they are manufacturing earnings.'" (App. 33.)[4]

The court also held that the TAC adequately pled scienter and materiality based on the alleged statements of confidential sources. But many of those sources did not work for Daou at the relevant time and many others had no personal

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[4] The Ninth Circuit acknowledged that, even under its very generous (although incorrect) reading of the TAC: "The TAC does not allege any revelation of Daou's true financial health prior to August 1998. Thus, as the TAC reads now, any loss suffered between $34.375 [the stock's high] and $18.50 [where the stock was trading in August of 1998], cannot be considered causally related to Daou's allegedly fraudulent accounting methods because before the revelations began in August 1998, the true nature of Daou's financial condition had not yet been disclosed." (App. 34.) Of course, in fact the TAC makes no allegation that the "truth became known" in August of 1998.

knowledge of the facts, or had no plausible basis for having personal knowledge of the facts.

The Ninth Circuit denied a subsequent petition by defendant for rehearing *en banc*. (App. 140.)

REASONS FOR GRANTING THE PETITION

To curb abuses under the Nation's securities fraud statutes, Congress enacted the Private Securities Litigation Reform Act ("PSLRA"), 15 U.S.C. § 78u-4(a)-(f). *See Dura Pharms., Inc.* v. *Broudo*, 125 S. Ct. 1627, 1634 (2005) (citing H.R. Rep. No. 104-369 at 31 (1995) (Conf. Rep.) ("criticizing 'abusive' practices including 'the routine filing of lawsuits . . . with only a faint hope that the discovery process might lead eventually to some plausible cause of action'").) A continuation of these abuses "would permit a plaintiff 'with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the [discovery] process will reveal relevant evidence." Such a rule would tend to transform a private securities action into a partial downside insurance policy." *Id.* (citations omitted, alteration in original).

This case presents two important federal questions regarding the enforcement of Congress's attempts to curb abuses in securities class actions. As shown below, this Court should grant review to resolve the Ninth Circuit's apparent intransigence to apply this Court's holding in *Dura*, and to resolve the conflicts in the Circuits as to the propriety of relying on confidential sources to support securities fraud claims.

First, guidance from this Court on the application of *Dura* with respect to what is necessary at the pleading stage to allege the essential element of loss causation is necessary to ensure that the Court's holding in *Dura* is not undone by courts reluctant to follow the letter of *Dura's* holdings.

Second, this case presents an opportunity to resolve an issue regarding the interpretation of the PSLRA which has confused and confounded courts across the country—the use of confidential witnesses to support securities fraud claims. In this case, the Ninth Circuit found that the TAC had adequately alleged materiality and scienter, as well as other elements of a securities fraud claim, based largely, or in some cases wholly, on the alleged statements of confidential witnesses. It is unclear why that would ever be appropriate, since discovery in civil actions inevitably will disclose who the witnesses are. Several district courts have held that the PSLRA's requirements of pleading certain facts with particularity prohibits the use of confidential witnesses. Most of the Courts of Appeals have permitted cases under the PSLRA to proceed based solely on allegations in complaints from confidential witnesses. However, there is a split among the Courts of Appeals as to what requirements, if any, must be met before a case can proceed under the PSLRA based on allegations from confidential witnesses. This Court's review of the permissible use of confidential witnesses in securities fraud actions is warranted to ensure a uniform enforcement of Congress's efforts to curb abusive suits under the Nation's securities laws by adopting the PSLRA.

I. THE NINTH CIRCUIT'S DECISION ON LOSS CAUSATION IS IN DIRECT CONFLICT WITH THIS COURT'S RECENT DECISION IN *DURA PHARMACEUTICALS, INC.* V. *BROUDO* AND CONFLICTS WITH THE VIEW OF LOSS CAUSATION ADOPTED BY OTHER COURTS OF APPEALS.

In *Dura*, this Court rejected the Ninth Circuit's holding that a plaintiff in a securities class action could meet the loss causation requirement by alleging an inflated purchase price. 125 S. Ct. at 1629. The Court held that the plaintiffs there had failed to allege loss causation properly when they failed to allege a time when the "share price fell significantly after

the truth became known" and failed to allege a causal connection between the alleged fraud and plaintiffs' loss. *Id.* at 1631-34.

While ostensibly applying this Court's holding in *Dura*, the Ninth Circuit held in this case that the TAC stated a claim for securities fraud. It did so despite the fact that the plaintiffs in this case made no allegation that the "truth became known" at a particular time, or that any misrepresentation by the defendants caused their loss. The basis for its opinion, which is inconsistent not only with this Court's holding in *Dura*, but also with the decisions of other Courts of Appeals, is that it is sufficient to allege that the plaintiffs purchased stock at an inflated price and that the stock later fell in price. (App. 30-34.) That is nothing more than a thin gloss on the Ninth Circuit's original holding in *Dura*—that a plaintiff in a securities class action could meet the loss causation requirement merely by alleging an inflated purchase price. If the stock price had never fallen, any claim would be unsupported by damages. The fact that the stock price dropped, however, is not a substitute for loss causation.

This Court should grant review to make clear that the Ninth Circuit's approach is inconsistent with this Court's holding in *Dura* and to resolve the intercircuit split created by the Ninth Circuit's attempt to breathe life into its original, rejected view of loss causation.

A. This Court's Decision In *Dura*, And Decisions Of Other Courts Of Appeals, Requires Adequate Pleading Of Loss Causation.

1. The *Dura* Decision.

In *Dura*, plaintiffs alleged that during the class period (April 15, 1997 to February 24, 1998) defendants made misrepresentations concerning its profits and the likelihood that the Food and Drug Administration ("FDA") would approve a certain product. *Dura*, 125 S. Ct. at 1630. On February 24, 1998, Dura disclosed that the company's earnings would be

lower than previously expected, primarily due to slow drug sales. *Id.* At the same time, Dura's shares fell from $39 per share to about $21 per share. *Id.* In November 1998, Dura's stock fell again when the company announced that the FDA would not approve its product. *Id.* Plaintiffs alleged that in reliance on the integrity of the market, they paid artificially inflated prices for their stock and suffered damages. *Id.* This Court held that these allegations were insufficient to plead loss causation because plaintiffs failed "to claim that Dura's share price fell significantly after the truth became known" and failed to allege the causal connection between the misrepresentation and the loss. *Id.* at 1634.

In so holding, the Court emphasized that securities losses may be caused by a whole host of factors, including "changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events." *Id.* at 1632. Thus, while the "securities statutes seek to maintain public confidence in the marketplace . . . through the availability of private securities fraud actions," "the statutes make these latter actions available, not to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause." *Id.* at 1633.

"[A]llowing a plaintiff to forgo giving any indication of the economic loss and proximate cause that the plaintiff has in mind would bring about harm of the very sort the statutes seek to avoid" because "[i]t would permit a plaintiff 'with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the [discovery] process will reveal relevant evidence.'" *Id.* at 1634 (italics and bracketed language in original).

This Court therefore rejected the Ninth Circuit view in *Dura* that pleading stock purchases at inflated prices was sufficient to allege loss causation. As noted above, that view

would erroneously permit securities fraud claims to proceed even when the misrepresentation did not "proximately cause any economic loss." *Dura*, 125 S. Ct. at 1633.

2. The Ninth Circuit Continues to Apply a Loss Causation Rule Different from Other Circuits.

This Court granted review in *Dura* because the "Ninth Circuit's views about loss causation differ from those of other Circuits that have considered this issue." *Dura*, 125 S. Ct. at 1630. The Ninth Circuit's decision below is equally at odds with the views of its sister circuits. This fact is made readily apparent by examining how other Courts of Appeals have addressed loss causation in securities fraud cases, as well as other decisions issued since *Dura* that have interpreted the requirements for adequately pleading loss causation.

As commentators have recognized, post-*Dura* the Courts of Appeals continue to follow different approaches to the requirements of loss causation.[5] The Eleventh Circuit, in a pre-*Dura* decision, and the Second and Sixth Circuits, in post-*Dura* decisions, have held that the PSLRA requires specific allegations of a causal connection between defendant's misrepresentation and the declining stock value. *See Robbins* v. *Koger Props., Inc.*, 116 F.3d 1441 (11th Cir. 1997) (one of the cases this Court expressly endorsed in *Dura*); *Lentell* v. *Merrill Lynch & Co.*, 396 F.3d 161 (2d Cir. 2005) (following *Dura*); *D.E. & J. Ltd. P'ship* v. *Conaway*, Nos. 03-2334, 03-2417, 2005 WL 1386448 (6th Cir. Jun. 10, 2005) (same). As explained below, each of these courts rejected the view, adopted by the Ninth Circuit below, that loss causation is adequately pled in a securities fraud class action where there

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[5] *See, e.g.*, Richard A. Spehr & Joseph De Simone, *The Battleground After "Dura" Decision: Differences remain over implementing standard for pleading loss causation*, N.Y. L. Jl. (Aug. 22, 2005) (discussing cases).

is an alleged fraudulent act, an announcement of earnings that conflicts with earlier reports, and a decline in stock price.

a. *Robbins* is one of four Court of Appeals decisions this Court cited favorably in *Dura* regarding the proper interpretation of the loss causation element. *Dura*, 125 S. Ct. at 1633. As in the present case, the plaintiffs in *Robbins* alleged that: (a) earnings were over-stated because of a knowing violation of GAAP; (b) a subsequent company announcement, while not explicitly addressing the application of GAAP, was in conflict with the prior earnings descriptions; and (c) following the announcement, the stock price fell. 116 F.3d at 1444-45. The Eleventh Circuit held that these facts did not describe "a connection between [the] misrepresentations and the decline in price" because the "misrepresentations [were] still present" after the announcement "and, therefore, the value plaintiffs lost was not caused by [the] misrepresentations." *Id.* at 1448.

b. In *Conaway*, the plaintiffs brought securities fraud claims on behalf of all purchasers of Kmart stock from March 13, 2001 to May 15, 2001. According to the plaintiffs, from March 13, 2001 to August 7, 2002, Kmart's stock rose as a result of defendants' various acts of accounting fraud, which falsely painted a picture of financial success. *See Conaway*, 2005 WL 1386448, at *1. From October through December 2001, the company began reporting negative sales information and on January 22, 2002, filed for bankruptcy. The bankruptcy was necessitated by, among other things, below-plan sales and earning performance in the fourth quarter. *Id.* at *2. Finding that the complaint did not differ in any material way from *Dura*, the Sixth Circuit rejected the plaintiffs' contention that the bankruptcy announcement could establish loss causation. *Id.* at *5-*6. As here, the Sixth Circuit noted that the announcement failed to disclose any prior misrepresentations and that "the observation that a stock price dropped on a particular day, whether as

a result of a bankruptcy or not, is not the same as an allegation that a defendant's fraud caused the loss." *Id.* at *6.

c. The Second Circuit's decision in *Lentell* v. *Merrill Lynch & Co.*, 396 F.3d 161 (2d Cir. 2005), also demonstrates the conflict between the other circuits' approach to loss causation and the Ninth Circuit's decision here. In *Lentell*, plaintiffs sued Merrill Lynch and one of the firm's former analysts, alleging that certain research reports were false and misleading and that the stock prices of clients of the firm's investment banking business were artificially inflated. *Id.* at 165. While there was a drop in the value of the stock, the court affirmed the dismissal of the complaint because the plaintiffs failed to adequately allege loss causation. *Id.* at 173.

The Second Circuit held that "to establish loss causation, 'a plaintiff must allege . . . that the *subject* of the fraudulent statement or omission was the cause of the actual loss suffered, i.e., that the misstatement or omission concealed something from the market that, when disclosed, negatively affected the value of the security." *Id.* at 173 (emphasis in original, citation omitted). But the plaintiffs in *Lentell* made "no allegation that the market reacted negatively to a corrective disclosure regarding the falsity of Merrill's 'buy' and 'accumulate' recommendations and no allegation that Merrill misstated or omitted risks that did lead to the loss." *Id.* at 175. While the plaintiffs argued that they *had* "alleged a corrective disclosure to the market, in alleging that Merrill's eventual downgrades of . . . [the] stock . . . negatively impacted the price of those securities," the court held these allegations insufficient. *Id.* "These allegations do not amount to a corrective disclosure, . . . because they do not reveal to the market the falsity of the prior recommendations." *Id.* at 175 n.4.

d. The district court in *In re Tellium, Inc. Securities Litigation*, No. 02-CV-5878 (FLW), 2005 WL 2090254 (D.N.J. Aug. 26, 2005), reached a similar conclusion when interpret-

ing *Dura*. There, the plaintiffs alleged that Tellium went forward with its initial public offering based on the strength of three contracts with its three main customers, despite defendants' knowledge that those contracts were not at all solid. The plaintiffs in *Tellium* alleged that they paid artificially inflated prices for their stock as a result of the defendants' fraud. *Id.* at *2. The *Tellium* plaintiffs also alleged that the share price fell as major disclosures were made regarding Tellium's prospects. Emphasizing *Dura*'s cautionary note that losses can be caused by a multitude of factors, the court found that plaintiffs had not sufficiently alleged a causal connection between the alleged fraud and any loss suffered. *Id.* at *3. The court held that the plaintiffs "failed to allege a *corrective* disclosure, or some other *corrective* element" that caused them loss. *Id.* (emphasis added). As the court stated, their claims failed because the "[p]laintiffs must allege that at some point, the concealed scheme was disclosed to the market," *id.*, and—as here—they did not do so.

The courts in each of the cases discussed above are true to this Court's holding in *Dura*: to survive a motion to dismiss, the plaintiffs in a securities fraud action must allege that the particular fraudulent act by the defendant that is the subject of their complaint caused their loss. The failure to do so is fatal to their claim. The Ninth Circuit, as detailed below, has nonetheless once again decided to part ways and create its own standard for loss causation.

B. The Ninth Circuit Erred In Concluding That The Loss Causation Requirement Is Satisfied Based On Allegations Of A Purchase Of Stock At An Inflated Price And A Subsequent Decline In Stock Price.

In reaching its conclusions below, the Court of Appeals rendered this Court's decision in *Dura* a legal nullity within the Ninth Circuit. While *Dura's* holding requires a causal link to the misrepresentation, the court below requires merely

an allegation of purchases at an inflated price, and a drop in stock price, even though the "truth never became known." An analysis of the allegations in this case and the Ninth Circuit's holdings demonstrate the shortcomings of the decision and why it is important that this Court not let the Ninth Circuit, or other courts, stray from the holding of *Dura*.

1. Here, the TAC alleges that Daou's share price fell on some undisclosed date after August 13, 1998, when the Company filed a Form 10-Q that accurately reported its earnings and costs, but reported numbers that were different from those stated to analysts two weeks earlier. The share price fell again after October 28, 1998, when the Company announced "extremely poor results for the 3Q98." (TAC ¶¶ 78, 82.) These allegations fail under *Dura*, however, because there is no connection drawn between these two dates (or at any time) and "the truth [becoming] known" regarding the Company's alleged misapplication of POC. Indeed, the TAC concedes the opposite—that the alleged "truth" did not become known on these dates, and, in fact, other factors caused the decline in Daou's share price.

a. *The August 13, 1998 Allegations.* According to the TAC, on August 13, 1998 Daou filed its Form 10-Q "and the impact of defendants' financial shenanigans began to leak out." (TAC ¶ 78.) More specifically, the TAC alleges:

> In its Form 10-Q, the Company reported figures that were entirely different than what defendants had stated just two weeks earlier in Daou's July 29, 1998 press release and conference call to analysts. Although the Company had represented in its July 29, 1998 press release that earnings excluding merger charges were $0.12 and that its general and administrative expenses for the second quarter were $2.34 million and its merger expenses were $2.9 million, its Form 10-Q revealed a different story. According to its Form 10-Q, the Company's general and administrative expenses were actually $3.54

> million while merger-related expenses were only $1.02 million, revealing that the Company's operating income expenses before merger was only $0.08, or 33% less than originally reported.

The TAC then alleges that, on an unidentified date after August 13, 1998, an analyst speculated that the 10-Q raised concern about whether the Company had been accurately reporting earnings, and that "on the day following the revelation, the Company's stock price fell $5.75 per share to $12.75 in heavy trading, but continued to trade at artificially inflated levels through the remainder of the Class Period due to defendants' continued false statements." (TAC ¶ 79, 80 (emphasis added).)

On their face, these allegations show that the discrepancy between the Form 10-Q and Daou's statements two weeks earlier (and hence the drop in stock value) had nothing to do with POC—the discrepancy related solely to general and administrative ("g&a") and merger expenses. No connection is made, whatsoever, between this treatment and the sole accounting discrepancy alleged in the TAC—Daou's application of POC. Accordingly, as in *Dura* and the other cases discussed above, these allegations provide no support for Respondents' "loss causation" theory.

The allegations concerning the analyst's statement also do not establish loss causation under *Dura*. As a threshold matter, the analyst's statement is pure speculation. Moreover, the analyst's statement regarding earnings necessarily relates to g&a and merger expenses since it concerned the different numbers in the Form 10-Q. Because the TAC's only alleged accounting misrepresentations relate to Daou's application of POC, and have nothing to do with Daou's treatment of g&a and merger expenses, and since there is nothing in the analyst's statement drawing any connection between his speculative comment and Daou's application of POC, Respondents have failed to allege any facts tending to

establish that the decline in Daou's stock value was precipitated by Daou's alleged misapplication of POC.

Further, the allegations concerning the events of August 13, 1998, cannot establish loss causation because they actually concede the opposite—that the alleged "truth" did *not* become known on this date. Specifically, the TAC alleges that, as of this date, the stock continued to trade at allegedly "artificially inflated levels . . . due to defendants' continued false statements." (TAC ¶ 80 (emphasis added).) According to the TAC, then, as of this date, the supposed "truth" had not become known about the Company's alleged misapplication of POC.

Finally, as a chart of Daou's stock price Respondents filed with the TAC reflects, August 13, 1998, was roughly a quarter of the way into an ongoing price drop that neither sped up nor slowed down on this date. Instead, the stock price continued on the trend line it had been on for some time. The trend line did not change at all on August 13, 1998, and the alleged "revelation" caused nothing.

b. *The October 28, 1998 Allegations.* As with the events of August 13, 1998, no link is made between the "disclosures" of October 28, 1998, and the alleged POC violations. Moreover, even if such a link were made, the TAC itself establishes that the October 28 events did not cause a drop in the stock price.

According to the TAC, "as a result" of the October 28, 1998, "announcements," the Company's "stock dropped to as low as $3.25." (TAC ¶ 83.) However, these allegations fail under *Dura* because Respondents do not set forth facts tending to establish that, as of this date, the market knew of the alleged POC violations.

Also fatal to Respondents' claim of loss causation is the fact that the October 28 announcements did not cause a permanent loss of stock value. Rather, as the chart within the TAC demonstrates, in the weeks following October 28, 1998,

the stock price steadily rose, ultimately more than doubling in the next three months from the October 28, 1998, share price.

2. In sum, there is no material difference between what was pled with respect to loss causation here and what was held insufficient in *Dura*, *Robbins*, *Conaway*, or *Lentell*.

First, the TAC does not allege any moment in time when the truth became known concerning the precise misrepresentation alleged in the TAC—that Daou was violating POC.

Second, as in *Robbins*, the TAC alleges that the inflated stock price survived the August 13, 1998, earnings disclosure.

Third, the TAC does not allege a causal link between the disclosure of a possible misapplication of POC and a drop in stock price. *Dura*, *Robbins*, *Conaway*, and *Lentell*, require this linkage, and hold its absence is a failure to plead loss causation.

Finally, the chart of the Company's stock price over time, contained in the TAC, rebuts any contention that the stock price changed, permanently and for the worse, in the immediate wake of the August 13, 1998, Form 10-Q filing or the October 28, 1998, earnings announcement. This last shortcoming is particularly telling. The stock price on particular dates is an objective fact that cannot be changed by amendment of the TAC. That the trend in price did not change in the immediate days after August 13, 1998, now is immutable. So too is the fact that the stock price temporarily dropped after October 28, 1998, but then quickly rose to more than double its October 28, 1998, price. (TAC ¶ 7.) In *Dura*, the Court found the "most important[]" aspect of the plaintiffs' claims was that while the plaintiffs alleged paying an inflated purchase price for their stock, they did not claim an economic loss attributable to the misrepresentation. 125 S. Ct. at 1630. Here, not only do the Respondents have a similar gap

in the TAC, but for the reasons just outlined, it is not a gap that now can be cured.

* * *

This Court recognized the importance of resolving the intercircuit split regarding loss causation when it granted the petition for a writ of certiorari in *Dura*. That same rationale applies with equal force, if not more, here. The Ninth Circuit, applying *Dura* in name only, is continuing to allow securities fraud claims to go forward based solely on allegations of purchases of stock at inflated prices. The only difference is that here the Ninth Circuit added a requirement that there also be a subsequent stock price decline. For the reasons stated above, and acknowledged by this Court in *Dura*, that is a distinction without a difference. The continuing Ninth Circuit position permits cases to proceed without allegations of proximate cause of economic loss. *Dura*, 125 S. Ct. at 1633. This Court's review and guidance will ensure that the unanimous holding in *Dura* is not undone by the lower courts.

II. THE COURT SHOULD RESOLVE INTERCIRCUIT CONFLICTS REGARDING THE USE OF CONFIDENTIAL SOURCES IN SECURITIES FRAUD CLASS ACTION COMPLAINTS.

In an effort to circumvent the PSLRA's requirements of particularity, a growing trend in securities fraud class actions is to fill voids in specificity with reliance on confidential sources. This Court has not ruled on the propriety of the use of confidential witnesses in complaints filed under the PSLRA. A growing number of Courts of Appeals, however, have permitted reliance on confidential witnesses at the pleadings stage, albeit by applying various and differing factors for finding the use of such witnesses acceptable. By contrast, a number of other courts have held that the PSLRA does not permit the reliance on confidential witnesses. This

Court should also grant review because the view adopted by the Ninth Circuit below—and held by other Courts of Appeals—is in error, and is incompatible with the PSLRA's particularity requirements.

A. The Ninth Circuit's Decision Adds To An Existing Intercircuit Conflict.

Under the PSLRA, allegations relating to scienter, or allegations of misrepresentations or omissions made on "information and belief," must be pled with particularity. 15 U.S.C. § 78u-4(b)(1) and (2). Despite these requirements, the First, Second, Third, Fifth and Ninth Circuits have held that plaintiffs in securities fraud actions can support their complaints through reliance on allegations attributed to confidential sources. *See, e.g.*, App. 1-42; *Cal. Public Employees' Retirement Sys.* v. *Chubb Corp.*, 394 F.3d 126, 146 (3d Cir. 2004); *In re Cabletron Sys., Inc.*, 311 F.3d 11, 28 (1st Cir. 2002); *ABC Arbitrage Plaintiffs Group* v. *Tchuruk*, 291 F.3d 336, 351-53 (5th Cir. 2002); *Novak* v. *Kasaks*, 216 F.3d 300 (2d Cir. 2000). These circuits purport to place some restrictions on the use of confidential sources, but these restrictions vary from circuit to circuit. The Tenth Circuit permits reliance on confidential sources to state a claim, and does not make any effort to "test" the reliability of these sources. *See Adams* v. *Kinder-Morgan, Inc.*, 340 F.3d 1083 (10th Cir. 2003). The Eighth Circuit permits the reliance on confidential sources to allege scienter, but not for allegations of misrepresentations or omissions that are based on information and belief. *See Fla. State Bd. of Admin.* v. *Green Tree Fin. Corp.*, 270 F.3d 645 (8th Cir. 2001).

Several district courts have adopted the view that a claim cannot be stated based on confidential sources because the PSLRA requires disclosures of these sources even at the pleading stage. *See, infra*, at Part II.B.

A sampling of these cases, and the various approaches to this issue, are discussed below. In short, this is a significant

question of federal law that has generated a conflict between the Courts of Appeals that is ripe for this Court's consideration.

1. The Majority View.

A majority of the Courts of Appeals have held that a plaintiff in a securities fraud action need not disclose the identity of confidential sources relied on to support allegations in a complaint. Those circuits generally have followed the Second Circuit's approach in *Novak* v. *Kasaks*, 216 F.3d 300 (2d Cir. 2000). These other circuits, however, have placed additional restrictions on the use of confidential sources to ensure their reliability.

a. In *Novak*, the district court held that the PSLRA required disclosure of the identity of the confidential sources—in that case, several former employees of the defendant. *See id.* In reversing the district court, the Second Circuit held that the PSLRA "may compel revelation of confidential sources under certain circumstances," but there was no per se requirement of disclosure. *See id.* at 313.

In reaching its conclusion, the *Novak* court held that while 15 U.S.C. § 78u-4(b)(1) requires the complaint to include "all facts" upon which such information and belief allegations are based, Congress could not have intended to mean all facts. Instead, the court held, plaintiffs must only plead "sufficient facts" to support such an allegation. *See id.* at 313-14. On the basis of this interpretation of the PSLRA, the court held that alleged statements from confidential sources can be used in either of two situations. First, confidential sources can be used if the complaint sets forth other factual allegations, such as documentary evidence, which are sufficient alone to support a fraud allegation. *See id.* at 314. Second, confidential sources can be relied on when the "other facts" are insufficient, if the confidential sources are "described in the complaint with sufficient particularity to sup-

port the probability that a person in the position occupied by the source would possess the information alleged." *Id.*

The Fifth Circuit has adopted the Second Circuit's holding in *Novak*. *See ABC Arbitrage* v. *Tchuruk*, 291 F.3d 336, 351-53 (5th Cir. 2002) ("[W]e see no reason to embroider the multi-step analysis of the Second Circuit and accept it as stated.")[6]

b. The First Circuit in *In re Cabletron Sys., Inc.*, 311 F.3d 11, 28 (1st Cir. 2002), adopted the general reasoning of *Novak*, but established non-exhaustive criteria to judge whether it is appropriate to rely on the confidential sources in question. The court held that review of complaints with confidential sources in securities fraud cases required case-by-case analysis, which "involves an evaluation, *inter alia*, of the level of detail provided by the confidential sources, the corroborative nature of the other facts alleged (including from other sources), the coherence and plausibility of the allegations, the number of sources, the reliability of the sources, and similar indicia." *Id.* at 30.

c. The Third Circuit also adopted *Novak's* general approach, but held that to state a securities fraud claim based on confidential sources the complaint must disclose the time period that the alleged former employees worked at the company, the dates on which the relevant information was acquired, and how the sources had access to the information. *See Cal. Public Employees' Retirement Sys.* v. *Chubb Corp.*, 394 F.3d 126, 146 (3d Cir. 2004). For example, in *Chubb*, the court held that "branch employees" who worked outside the relevant department would not have necessarily had per-

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[6] Interestingly, the Fifth Circuit also stated that if neither of *Novak*'s two requirements were met, the party may be forced to disclose the identity of the confidential source(s). *See id.* at 353. This suggests that merely naming a confidential source can be a substitute for the fact that there is no basis to believe the source has adequate personal knowledge of the facts, or the lack of sufficient corroborating facts.

sonal knowledge of the facts they alleged. Notably, the court held insufficient the claims of a former employee who alleged accounting fraud because the employee "held positions that would not appear to render them privy to the company's bookkeeping practices, let alone the specific accounting that went into the company's financial reporting." *Id.* at 152.[7]

d. In this case, the Ninth Circuit expressly adopted the approach of the courts in *Novak* and *Cabletron*. However, in applying the *Cabletron* factors, the court did not analyze the reliability of the confidential sources, including any support for the conclusion that these witnesses had personal knowledge, which was emphasized in *Cabletron* and *Chubb*. Indeed, commentators have noted that the Ninth Circuit below adopted a more "lenient standard[] for assessing the credibility of confidential witnesses" as compared to other circuits. Laurie Smilan, *Issuer Class Actions: Noteworthy Decisions and Trends of 2004/2005*, at 203 (PLI Corp. Law & Practice, Course Handbook Series No. 1505, 2005).

A review of the decision below makes this clear. The district court ruled that the Second Amended Complaint did not meet the governing pleading standards, in part due to lack of detail and in part due to a failure to demonstrate the source of information underlying the factual allegations. In response, the Respondents simply repackaged the same allega-

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[7] Several district courts have also held that, at a minimum, allegations attributed to confidential witnesses need to contain specific details regarding the basis for their personal knowledge and the events need to be described in detail. *See, e.g., In re Northpoint Commc'ns Group, Inc., Sec. Litig.*, 184 F. Supp. 2d 991, 999-1000 (N.D. Cal. 2001); *see also In re U.S. Aggregates, Inc. Sec. Litig.*, 235 F. Supp. 2d 1063, 1074 (N.D. Cal. 2002) (vague allegations of defendants' authority, hearsay assertions of defendants' scienter and conclusory statements that "numbers were manipulated" held insufficient). At least one district court has held that each sentence in a complaint should be explicitly attributed to a particular confidential witness, and should establish how that source gained his knowledge. *See In re Ramp Networks, Inc.* 201 F. Supp. 2d 1051, 1067 (N.D. Cal. 2002).

tions, added little to no detail, and sourced their allegations to a variety of "confidential witnesses." The district court found these witnesses lacked reliability. (App. 122.)

The Ninth Circuit, however, held that the "confidential witnesses" were described with "sufficient particularity" based on the fact that "plaintiffs number each witness and describe his or her job description and responsibilities. In some instances, plaintiffs provide the witnesses' exact title and to which Daou executive the witness reported." (App. 11.) But the Ninth Circuit did not discuss how many of these witnesses had access to the information they purport to have, how their positions provided them with personal knowledge of these facts, or when they were employed by Daou.

The fact is that a review of the TAC shows that it often sources conclusory allegations to confidential witnesses, with no allegation establishing the witness' personal knowledge. For the vast majority of confidential witness allegations, there are no facts establishing that the witness worked at Daou, or that the alleged misconduct occurred, during any of the relevant time periods.

For example, in concluding that the confidential witness allegations here are sufficient, the Ninth Circuit relied, in particular, on CW6 and CW9. (App. 11-12.) Yet, an examination of the allegations pertaining to these witnesses exemplifies why the use of confidential witnesses allows securities fraud plaintiffs to hide, within their prolix complaints, the fact that they cannot meet the PSLRA's high standards for alleging securities fraud.

First, because the TAC fails to allege *when* these two confidential witnesses worked at Daou, it is unknown whether they even worked at Daou during the relevant time period. (*See* TAC ¶ 20(f) & (i).) Without such information, it is impossible to determine whether the witnesses have any personal knowledge of the "facts" attributed to them.

Even more troubling is the fact that, although the Ninth Circuit relied on CW6 (who is alleged to be a former executive who worked in the Finance Department) to satisfy itself that the descriptions of the confidential witnesses are sufficiently particularized, the inherently confusing nature of these types of allegations obscured the fact that within the 101 pages of the TAC, *there is not a single allegation supporting plaintiffs' fraud claim that is attributed to CW6.* The *only* allegation in the entire complaint that is attributed to CW6 is found at paragraph 59(g), and merely states that "[a]ccording to CW1, CW3, CW4, CW6, CW7, the ManFact data was compiled into a Monthly Project Report which was sent to G. Daou, D. Daou, McGee, and McNeill at the close of each month and quarter." This is a benign fact that does nothing to support Respondents' allegations of fraud. Moreover, the attribution of this allegation to CW6 appears to be a typographical error—in the numerous other instances where the TAC repeats this same allegation, CW6 is *not* included in the allegation (but CW16 is). (*See* TAC ¶¶ 46(d), 49(d), 52(f), 62(g), 66(i), (69(j)). Thus, the confusing and unsubstantiated nature of these "confidential witness" allegations allowed Respondents here to convince the Ninth Circuit that they had met the PSLRA's heightened pleading burden merely through pleading the "existence" of CW6.

Although the other witness relied on by the Ninth Circuit—CW9—is connected with allegations regarding the company's alleged improper revenue recognition practices (*see, e.g.*, TAC ¶ 45(b)(c)), there is no alleged basis for concluding that CW9 would have personal knowledge of the information attributed to him. According to the complaint, CW9 is a former Regional Vice President of Sales who was responsible for *reporting* sales information, "such as sales status/backlog and forecast/pipeline information." (TAC ¶ 20(i)). Missing are any allegations that CW9, a sales executive, had any involvement with or knowledge of Daou's accounting practices at all, much less during the relevant time period. Again, if Respondents had been required to name

their witnesses, they would not be able to so easily evade the PSLRA's heightened pleading requirements by sprinkling their complaints with confidential witness allegations that, upon close examination, provide no support to their claims of fraud.

2. The Tenth Circuit View.

The Tenth Circuit has held that securities fraud plaintiffs may rely on confidential sources, but has rejected even the minimal requirements of corroboration adopted by the Second Circuit in *Novak*. In *Adams* v. *Kinder-Morgan, Inc.*, 340 F.3d 1083 (10th Cir. 2003), the Tenth Circuit held that confidential sources were acceptable and that the holding in *Novak* requiring either identification of sufficient documentary support or a sufficiently particularized description of the confidential sources was too restrictive, and not required by the PSLRA. *See id.* at 1101. In the view of the Tenth Circuit, "requiring plaintiffs to identify the source of the facts they allege is to require, in effect, that the plaintiffs plead their evidence in the complaint." *Id.* It rejected the view that Congress intended such a result when it adopted the PSLRA. *See id.*

3. The Eighth Circuit View.

The Eighth Circuit in *Florida State Board of Administration* v. *Green Tree Financial Corp.*, 270 F.3d 645 (8th Cir. 2001), held that alleged statements from confidential sources were permissible to support the element of scienter. *See id.* at 667-68. The court noted, however, that if the confidential sources were used to support the element of misrepresentation, then "an allegation based on information and belief should set forth the source of the information." *Id.* at 668 (quoting *Romani* v. *Shearson Lehman Hutton*, 929 F.2d 875, 878 (1st Cir. 1991).) The court went on to note that:

> [t]his rule was developed as a corollary to the rule that allegations of fraud regarding matters peculiarly within the opposing party's knowledge could be

> based on information and belief, so long as accompanied by a statement of the facts on which the belief was founded. *See Luce* v. *Edelstein*, 802 F.2d 49, 54 n. 1 (2d Cir. 1986); Harold S. Bloomenthal & Samuel Wolff, *Securities and Federal Corporate Law* § 16:12 n. 9, 16:25.6 n. 2 (1998). . . . Since a primary goal of the Reform Act was to prevent baseless strike suits, S. Rpt. No. 104-98 at 4, reprinted in 1995 U.S.C.C.A.N. at 683, our practice under Rule 9(b) of requiring disclosure of facts relied on for pleadings based on information and belief should obviously be continued under the Reform Act.

Id. at 667-68. Thus, in the Eighth Circuit, if the allegations at issue are the support for the misrepresentation claim, then the identity of the confidential sources must be disclosed.[8]

B. Several Lower Courts Have Held That The PSLRA Requires The Identification Of Confidential Sources.

Several district courts, relying on the legislative history of the PSLRA, have concluded that plaintiffs are *required* to name their confidential sources to state a claim. *See, e.g., In re Party City Sec. Litig.*, 147 F. Supp. 2d 282, 304 (D. N.J. 2001) (complaint must contain "names of confidential informants, employees, competitors and others who provide information"); *In re Nice Sys. Ltd. Sec. Litig.*, 135 F. Supp. 2d

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[8] Adding to the confusion is the fact that the Eight Circuit's distinction between anonymous sources used to show scienter and those used to support misrepresentations or omissions on information and belief makes no sense. Both allegations relating to scienter and allegations of misrepresentations or omissions made on information and belief must be pled with particularity. *See* 15 U.S.C. § 78u-4(b)(1) and (2). But reliance on anonymous sources to state a claim *is* an allegation "on information and belief." *See Barrie* v. *Intervoice-Brite, Inc.*, 397 F.3d 249, 259 (5th Cir. 2005), *modified*, 409 F.3d 653 (5th Cir. 2005); *ABC Arbitrage Plaintiffs Group* v. *Tchuruk*, 291 F.3d 336, 351 (5th Cir. 2002).

551, 570-71 (D. N.J. 2001) (same); *In re Tech. Chems. Sec. Litig.*, No. 98-7334, 2001 U.S. Dist. LEXIS 4851, at *19 n.7 (S.D. Fla. Mar. 20, 2001) (same); *see also In re Eng'g Animation Sec. Litig.*, 110 F. Supp. 2d 1183, 1192 (S.D. Iowa 2000) (requiring disclosure of identity of confidential source based on prior case law). Another district court held that the failure to do so may be fatal in at least some instances, as where the witness is the sole basis for plaintiff's claim that the defendant made knowingly false statements. *See In re McKesson, Inc. Sec. Litig.*, 126 F. Supp. 2d 1248, 1271-72 (N.D. Cal. 2000).

* * *

Congress intended to put a stop at the pleading stage to "largely groundless claim[s]" in securities class actions and to require those with meritorious claims to meet a heightened pleading standard for certain factual allegations. H.R. Rep. No. 104-369, at 31 (1995) (Conf. Rep.). For that reason, the PSLRA requires that allegations relating to scienter, or allegations of misrepresentation or omissions made on "information and belief," must be pled with particularity. 15 U.S.C. § 78u-4(b)(1)(B). That includes stating "all facts on which that belief is formed." *Id.* Particularly in light of Congress's intent in adopting the PSLRA, there is no reason to interpret this requirement as anything other than requesting disclosure at the pleading stage of the identity of confidential witnesses.

The issue of whether confidential sources can be used as a substitute for a full disclosure of all relevant facts at the pleading stage is unsettled by this Court. Even were this Court to adopt the view that the PSLRA permits reliance on confidential sources at the pleading stage, however, there must be strict limits on its use. At a minimum, the Court should accept review to resolve the intercircuit split regarding the criteria for determining when it is permissible to rely on confidential sources. This case presents an opportunity to reject the "lenient standards for assessing the credibility" of confidential sources adopted by the Ninth Circuit. L. Smilan,

supra. Review of this issue can restore the uniformity and strict requirements that Congress intended in passing the PSLRA.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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November 2005

APPENDIX

APPENDIX A

FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

In re: DAOU SYSTEMS, INC., SECURITIES LITIGATION,

GREG SPARLING; EUGENE KRABBENHOFT; PATRICK DE KRUYFF, Esq.; ROBERT ZARETSKY; ROD FORD; THOMAS V. HAGMAN; RICHARD W. WALSH; RICHARD TORIBIO; PAUL RABIN,

Plaintiffs-Appellants,

v.

GEORGES DAOU; DANIEL DAOU; FRED MCGEE; ROBERT MCNEILL; JOHN MORAGNE; DAOU SYSTEMS, INC.,

Defendants-Appellees.

No. 02-56989

D.C. No. CV-98-01537-L/CGA

In re: DAOU SYSTEMS, INC., SECURITIES LITIGATION,

GREG SPARLING; EUGENE KRABBENHOFT; PATRICK DE KRUYFF, Esq.; ROBERT ZARETSKY; ROD FORD; THOMAS V. HAGMAN; RICHARD W. WALSH; RICHARD TORIBIO; PAUL RABIN,

Plaintiffs-Appellees,

v.

GEORGES DAOU; DANIEL DAOU; FRED MCGEE; ROBERT MCNEILL; JOHN MORAGNE,

Defendants,

and

DAOU SYSTEMS, INC.,

Defendant-Appellant.

No. 02-57018

D.C. No. CV-98-01537-L/CGA

ORDER AND AMENDED OPINION

Appeal from the United States District Court for the Southern District of California M. James Lorenz, District Judge, Presiding

Argued and Submitted February 12, 2004 – Pasadena, California

Filed February 2, 2005 Amended June 21, 2005

Before: Betty B. Fletcher, Harry Pregerson, and Melvin Brunetti, Circuit Judges.

Opinion by Judge Brunetti

COUNSEL

Eric A. Isaacson, San Diego, California, for the plaintiffs-appellants-appellees.

Michael P. McCloskey, San Diego, California, for the defendants-appellees-appellants.

ORDER

The attached amended opinion is substituted for the original opinion filed on February 2, 2005, slip op. page 1385 and appearing at 397 F.3d 704 (9th Cir. 2005). With these amendments, Daou's petition for panel rehearing is denied and plaintiffs' "Motion to Amend Opinion to Conform with Controlling Precedent" is moot.

OPINION

BRUNETTI, Circuit Judge.

Plaintiffs, a class of former Daou Systems, Inc. ("Daou") investors who purchased Daou common stock between February 13, 1997 and October 28, 1998, allege that defendants Daou, Chief Executive Officer and Chairman of the Board Georges Daou ("G. Daou"), President and Director Daniel Daou ("D. Daou"), Chief Financial Officer and Senior Vice President Fred McGee, Chief Operating Officer and Executive Vice President Robert McNeill, and Director John Moragne systematically and fraudulently violated the Generally Accepted Accounting Principles ("GAAP") in order to artificially inflate the price of Daou's stock. Plaintiffs also allege that they incurred substantial personal losses due to their respective purchases of

Daou stock at fraudulently inflated prices. The district court, on several occasions, determined that plaintiffs had failed to state sufficiently particularized claims under the 1933 Securities Act and the 1934 Exchange Act and thrice granted plaintiffs leave to amend. Plaintiffs now appeal the district court's dismissal of their Third Amended Complaint ("TAC") with prejudice. Defendants also cross-appeal the district court's failure to consider, *sua sponte*, whether to impose sanctions against plaintiffs and plaintiffs' attorneys.

FACTS[1] AND PROCEEDINGS BELOW

Daou created, implemented, and supported computer networking systems for use in the healthcare field. Beginning with its first public offering in February 1997, Daou represented itself as a technologically astute company able to keep pace with the ever-changing medical field. For seven consecutive quarters, Daou reported "record" growing revenues and stated that the company's earnings per share ("EPS") had and would exceed market expectations. Daou allegedly touted "spectacular" results and "strong growth" while also reporting successful employee retention as well as an "extremely strong pipeline position."

Plaintiffs contend that Daou fraudulently inflated the price of its stock by reporting revenues before they were earned, in violation of GAAP. The company employed an accounting method known as the percentage-of-completion ("POC") method, which is used primarily to account for

[1] The following facts are taken from plaintiffs' third amended complaint and will be assumed true for purposes of the within review. *See Gompper v. VISX, Inc.*, 298 F.3d 893, 895 (9th Cir. 2002).

progress on long-term projects. Under this method, revenue from these projects could only be recognized based on the percentage of labor costs incurred to date compared to the total estimated labor costs for the project. Plaintiffs allege, however, that defendants would prematurely recognize revenue in contravention of the POC method. For example, plaintiffs allege that defendants systematically, without regard to labor costs incurred or estimated, recognized 20% of the contract revenue immediately upon signing products contracts, 40% of the contract revenue immediately after the equipment to be installed was ordered, and 50%-60% of the contract revenue as soon as the equipment was configured and tested. Plaintiffs contend that because of such artificial inflation of the price of Daou stock, Daou was able to acquire eleven companies, and Daou executives and their respective family members were able to sell nearly 2.5 million shares for a total of $54.67 million in improper proceeds. Plaintiffs also allege that to their detriment they purchased their Daou shares during the class period at artificially inflated prices and that, had they been aware of Daou's true financial results and condition, they would not have purchased their shares, or at least not at the prices paid.

Defendants counter that their method of accounting did not violate GAAP or their own stated policy, as they revealed in various disclosures that

> [c]ontract revenue for the development and implementation of network solutions is recognized on the percentage-of-completion method with progress to completion measured by labor costs incurred to date compared to total estimated labor costs. . . . *Revenues recognized in excess of amounts billed and project costs are classified as contract work in progress.*

(emphasis added). The district court agreed and determined that plaintiffs had failed to expose any financial tomfoolery on the part of Daou in its execution of the POC accounting method:

> Plaintiffs appear [to] argue that, because there was a variance between recognized and earned revenue, Defendants must have been engaged in accounting fraud. Their allegations that the funds in the work in progress account represented improperly recognized revenue are conclusory and appear to result from circular logic. Plaintiffs simply have not shown that recognizing unearned revenue and earmarking it for the work in progress account is anything but an exercise of Defendants' business judgment.

Such failure, the court concluded, proved fatal to plaintiffs' remaining claims, as, for example, if Daou's statements were not false and misleading, then defendants did nothing requiring an assessment of their scienter in making them. The court consequently dismissed plaintiffs' TAC with prejudice, and this appeal followed.

DISCUSSION

I. *Standard of Review*

We review dismissals under Federal Rules of Civil Procedure 9(b) and 12(b)(6) de novo. *Vess v. Ciba-Geigy Corp. USA*, 317 F.3d 1097, 1102 (9th Cir. 2003) (citations omitted). "[W]e accept the plaintiffs' allegations as true and construe them in the light most favorable to plaintiffs." *Gompper*, 298 F.3d at 895 (citations omitted). However, "[c]onclusory allegations of law and unwarranted inferences are insufficient to defeat a motion to dismiss for failure to state a claim." *In re VeriFone Sec.*

Litig., 11 F.3d 865, 868 (9th Cir. 1993) (citations omitted). "Dismissal without leave to amend is improper unless it is clear, upon de novo review, that the complaint could not be saved by any amendment." *Gompper*, 298 F.3d at 898 (citation and internal quotations omitted).

II. *Federal Securities Law*

Plaintiffs' TAC asserts five claims for relief, alleging (1) violation of section 10(b) and Rule 10b-5 of the 1934 Exchange Act against all defendants; (2) violation of section 20(a) of the 1934 Exchange Act against certain defendants; (3) violation of section 11 of the 1933 Securities Act against certain defendants; (4) violation of section 12(a)(2) of the 1933 Securities Act against certain defendants; and (5) violation of section 15 of the 1933 Securities Act against certain defendants.

a. *Section 10(b) of the Exchange Act of 1934*

Section 10(b) of the Exchange Act of 1934, 15 U.S.C. § 78j(b), makes it unlawful "for any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe[.]" SEC Rule 10b-5, promulgated under the authority of section 10(b), in turn, provides:

> It shall be unlawful for any person . . .
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary

> in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5. The basic elements of a Rule 10b-5 claim, therefore, are: (1) a material misrepresentation or omission of fact, (2) scienter, (3) a connection with the purchase or sale of a security, (4) transaction and loss causation, and (5) economic loss. *See Dura Pharms., Inc. v. Broudo*, 544 U.S. ___, 125 S.Ct. 1627, 1631 (2005).

It is well established that claims brought under Rule 10b-5 and section 10(b) must meet the particularity requirements of Federal Rule of Civil Procedure 9(b). *See Semegen v. Weidner*, 780 F.2d 727, 729, 734-35 (9th Cir. 1985). Rule 9(b) states that "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally."

Further, the enactment of the Private Securities Litigation Reform Act ("PSLRA") in 1995 significantly altered pleading requirements in private securities fraud litigation by amending the 1934 Exchange Act to require that a complaint "plead with particularity both falsity and scienter." *Gompper*, 298 F.3d at 895 (quoting *Ronconi v. Larkin*, 253 F.3d 423, 429 (9th Cir. 2001)); *see also Nursing Home Pension Fund, Local 144 v. Oracle Corp.*, 380 F.3d 1226, 1230 (9th Cir. 2004). A securities fraud complaint must now "specify each statement alleged to have

been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." *Gompper*, 298 F.3d at 895 (quoting 15 U.S.C. § 78u-4(b)(1)).

The complaint must also "state with particularity facts giving rise to a *strong* inference that the defendant acted with the required state of mind." *Id.* (quoting 15 U.S.C. § 78u-4(b)(2) (emphasis added in *Gompper*)); *see also In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 974 (9th Cir. 1999) ("*Silicon Graphics*") (facts must come closer to demonstrating intent as opposed to mere motive and opportunity). The stricter standard for pleading scienter naturally results in a stricter standard for pleading falsity, because " 'falsity and scienter in private securities fraud cases are generally strongly inferred from the same set of facts,' and the two requirements may be combined into a unitary inquiry under the PSLRA." *In re Vantive Corp. Sec. Litig.*, 283 F.3d 1079, 1091 (9th Cir. 2002) ("*In re Vantive*") (*quoting Ronconi*, 253 F.3d at 429). Thus, the complaint must allege that the defendants made false or misleading statements either intentionally or with deliberate recklessness. *Silicon Graphics*, 183 F.3d at 974.

Reliance on Confidential Witnesses

Because many of plaintiffs' allegations come from accounts of confidential witnesses, their use in satisfying the PSLRA's standard of particularity must be addressed. This circuit in *Silicon Graphics* cautioned about the use of unnamed sources in stating that "[i]t is not sufficient for a plaintiff's pleadings to set forth a belief that certain

unspecified sources will reveal, after appropriate discovery, facts that will validate her claim." *Silicon Graphics*, 183 F.3d at 985. Instead, to meet this particularity requirement for personal sources of information, this circuit has applied the Second Circuit's standard that "personal sources of information relied upon in a complaint should be 'described in the complaint with sufficient particularity to support the probability that a person in the position occupied by the source would possess the information alleged.'" *Nursing Home*, 380 F.3d at 1233 (quoting *Novak v. Kasaks*, 216 F.3d 300, 314 (2d Cir. 2000)). Where plaintiffs rely on both confidential witnesses and on other facts, "they need not name their sources as long as the latter facts provide an adequate basis for believing that the defendants' statements were false." *Novak*, 216 F.3d at 314; *see also Silicon Graphics*, 183 F.3d at 985 (complaint should include "adequate corroborating details").

The First Circuit has also adopted *Novak's* approach of "look[ing] at all of the facts alleged to see if they 'provide an adequate basis for believing that the defendants' statements were false.'" *In re Cabletron Sys., Inc.*, 311 F.3d 11, 29 (1st Cir. 2002) (citing *Novak*, 216 F.3d at 314). The First Circuit added that this approach "involves an evaluation, *inter alia*, of the level of detail provided by the confidential sources, the corroborative nature of the other facts alleged (including from other sources), the coherence and plausibility of the allegations, the number of sources, the reliability of the sources, and similar indicia." *Id.* at 29-30.

This circuit's approach does not necessarily require a plaintiff to name his or her confidential witnesses. However, this circuit does strictly adhere to the PSLRA's mandate that the complaint "state with particularity all

facts on which [a] belief is formed," and in so doing, requires that a plaintiff reveal "the sources of her information." *Silicon Graphics*, 183 F.3d at 985 (citation and internal quotation marks omitted). It is by this circuit's adoption of the Second Circuit's standard for evaluating personal sources of information, augmented by the First Circuit's suggested criteria for assessing reliability of confidential witnesses, that plaintiffs' complaint here should be evaluated. So long as plaintiffs reveal with particularity the sources of their information, the complaint will survive under the PSLRA. Naming sources is unnecessary so long as the sources are described "with sufficient particularity to support the probability that a person in the position occupied by the source would possess the information alleged" and the complaint contains "adequate corroborating details." *See Nursing Home*, 380 F.3d at 1233 (citation and internal quotation marks omitted); *Silicon Graphics*, 183 F.3d at 985.

Plaintiffs here describe the confidential witnesses with a large degree of specificity. Plaintiffs number each witness and describe his or her job description and responsibilities. In some instances, plaintiffs provide the witnesses' exact title and to which Daou executive the witness reported. For example, plaintiffs describe Confidential Witness #6 as follows: "Confidential Witness #6 ("CW6") is a former Daou executive who worked in the Finance Department. CW6 dealt with audit issues, Security and Exchange ("SEC") reporting and budget matters. As such, CW6 was familiar with Daou's process of collecting project cost information. CW6 reported to defendant McGee." Similarly, plaintiffs describe Confidential Witness #9 as follows: "Confidential Witness 9 ("CW9") is a former Daou Regional Vice President of Sales. As Vice President of

Sales, CW9 was responsible for reporting weekly or bi-weekly sales information, such as sales status/backlog and forecast/pipeline information, to Daou's Vice Presidents and corporate officers." Given the specificity of plaintiffs' descriptions of their confidential witnesses, we hold that plaintiffs have sufficiently met the PSLRA's requirements for confidential witnesses. We next determine whether plaintiffs have sufficiently pled the elements of a Rule 10b-5 claim in light of the PSLRA's heightened pleading standards.

1. *Material Misrepresentations or Omissions*

If "[p]roperly pled, overstating of revenues may state a claim for securities fraud, as under GAAP, 'revenue must be *earned* before it can be recognized.'" *Hockey v. Medhekar*, 30 F. Supp. 2d 1209, 1216 (N.D. Cal. 1998) (quoting *Provenz v. Miller*, 102 F.3d 1478, 1484 (9th Cir. 1996)) (emphasis in original). "To properly state a claim for accounting fraud, plaintiffs must 'plead facts' sufficient to support a conclusion that [d]efendant [] prepared the fraudulent financial statements and that the alleged financial fraud was material." *In re Peerless Systems, Corp. Sec. Litig.*, 182 F.Supp. 2d 982, 991 (S.D. Cal. 2002) (citations omitted) (alterations in original).

Violations of GAAP standards can also provide evidence of scienter. *Id.* (citing *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 203 (1st Cir. 1999)); *see also In re McKesson HBOC, Inc. Sec. Litig.*, 126 F. Supp. 2d 1248, 1273 (N.D. Cal. 2000) ("*In re McKesson*") ("[W]hen significant GAAP violations are described with particularity in the complaint, they may provide powerful indirect evidence of scienter. After all, books do not cook themselves."). To

support even a reasonable inference of scienter, much less a strong inference, "the complaint must describe the violations with sufficient particularity; 'a general allegation that the practices at issue resulted in a false report of company earnings is not a sufficiently particular claim of misrepresentation.'" *Greebel*, 194 F.3d at 203-04 (quoting *Gross v. Summa Four, Inc.*, 93 F.3d 987, 996 (1st Cir. 1996), *superseded by statute on other grounds as recognized in Greebel*, 194 F.3d at 197 ("strong" inference rather than "reasonable" inference now required for scienter)).

When pleading irregularities in revenue recognition, plaintiffs should allege "(1) 'such basic details as the approximate amount by which revenues and earnings were overstated'; (2) 'the products involved in the contingent transaction'; (3) 'the dates of any of the transactions'; or (4) 'the identities of any of the customers or [company] employees involved in the transactions.'" *In re McKesson*, 126 F. Supp. 2d at 1273 (quoting *Greebel*, 194 F.3d at 204) (alteration in *McKesson*). Plaintiffs need not allege each of those particular details, *see Greebel*, 194 F.3d at 204, but they must allege enough information so that "a court can discern whether the alleged GAAP violations were minor or technical in nature, or whether they constituted widespread and significant inflation of revenue." *In re McKesson*, 126 F. Supp. 2d at 1273.

Plaintiffs here contend that defendants systematically reported revenue, before it was earned in violation of GAAP. For example, they assert that Daou, "without regard to labor costs incurred or estimated," recognized 20% of the contract revenue immediately upon signing products contracts, 40% of the contract revenue immediately after the equipment to be installed was ordered, and 50%-60% of the contract revenue as soon as the equipment

was configured and tested. Moreover, plaintiffs assert that for one contract, the Centura Health project, certain Field Services personnel were told that they would receive $100 each if they would go into Daou's San Diego warehouse, plug in and turn on certain computers, and, in turn, bill eight hours of work. One confidential witness stated that he never received the $100, and when he inquired about the payment, he was told to "forget it ever happened." The only rationale for such occurrence, according to the confidential witness, was so Daou could prematurely recognize revenue on the Centura Health project.

Similar allegations were made in *Gross*, 93 F.3d at 995-96, *superseded by statute on other grounds*. The plaintiff in *Gross* asserted that Summa Four prematurely recognized revenue upon receipt of orders rather than on shipment of products, a practice that, in turn, allowed Summa Four to overstate significantly its revenues and earnings during the class period. *Id.* at 995. Gross substantiated such allegations by highlighting certain statements made by Summa Four executives at a board meeting indicating their intention to recognize $4.7 million in late-quarter earnings from the receipt of newly acquired orders, despite the fact that Summa Four generally required twelve to twenty weeks to fulfill such orders. *Id.* at 995-96. Board minutes also revealed that Summa Four's chief financial officer was working on a new "revenue recognition policy" that was to be "more formalized and somewhat more restrictive" than its previous policy. *Id.* at 996.

Although such assertions gave the court "pause," the court nonetheless held that Gross's complaint had not satisfied Rule 9(b)'s heightened pleading standards. *Id.* "A general allegation that the practices at issue resulted in a

false report of company earnings is not a sufficiently particular claim of misrepresentation to satisfy Rule 9(b)." *Id.* (citation and internal brackets omitted). The court determined that Gross had failed to allege any particulars to support his general allegation of inflated earnings through the use of improper accounting methods. "Specifically, he has not alleged the amount of the putative overstatement or the net effect it had on the company's earnings." *Id.* The court cited a number of cases in support of this conclusion, including *Shushany v. Allwaste, Inc.*, 992 F.2d 517, 522 (5th Cir. 1993) (allegation that company had adjusted the accounting of its inventory to inflate revenues and earnings does not sufficiently plead fraud where complaint does not explain, *inter alia,* how the adjustments affected the company's financial statements and whether they were material in light of the company's overall financial position), *Roots Partnership v. Lands' End, Inc.*, 965 F.2d 1411, 1419 (7th Cir. 1992) (allegation that company "failed to establish adequate reserves for its excessive and outdated inventory" does not satisfy Rule 9(b) where investor does not allege "what the reserves were or suggest how great the reserves should have been"), and *Cohen v. Koenig*, 25 F.3d 1168, 1173 (2d Cir. 1994) (fraud pled with sufficient particularity by setting out representations made, what financial figures were given, and what the alleged true financial figures were).

The case law indicates, therefore, that although overstatement of revenues in violation of GAAP may support a plaintiff's claim of fraud, the plaintiff must show with particularity how the adjustments affected the company's financial statements and whether they were material in light of the company's overall financial position. The district court here determined that plaintiffs

failed to make such a showing, noting that "despite an exhaustive search of the TAC, the Court was unable to locate and identify any allegations quantifying and contrasting the revenue Defendants *actually* recognized under the POC method and the revenue Defendants *should have* recognized if they had properly applied the POC method" (emphasis in original). "This information," the court stated, "is essential to surviving a motion to dismiss in this context." Moreover, the court noted, "Plaintiffs simply have not shown that recognizing unearned revenue and earmarking it for the work in progress account is anything but an exercise of Defendants' business judgment."

Upon independent review of plaintiffs' complaint, however, we find at least some specific allegations of how the adjustments affected the company's financial statements and whether they were material in light of the company's overall financial position. The complaint alleges myriad observations of accounting misfeasance (e.g., alleged manipulation of the books), and at least some of such allegations reveal that the amount of revenue Daou formally recognized was completely unrelated to the amount of labor incurred to date. According to Daou's stated method of revenue recognition -- the POC method -- Daou was to recognize revenue based on the percentage of labor costs incurred to date compared to the total estimated labor costs for the project. However, plaintiffs allege, and confidential witnesses corroborate, that

> Vice Presidents Ringwall and Mirabile would print out the ManFact reports containing actual labor and percent completion submitted by project managers, for the current month and quarter. According to CW3, CW4, CW7 and CW16, the ManFact data was compiled into a Monthly

> Project Report which was sent to G. Daou, D. Daou, McGee, and McNeill at the close of each month and quarter. . . . Based on the comprehensive Monthly Project Report. G. Daou, D. Daou, McNeill and McGee would adjust upward the percent of completion for projects.

If plaintiffs can in fact prove such intentional manipulation of the accounting principles, they will have shown that Daou's public statements regarding recognized revenue were materially misleading.

Moreover, it appears that the district court conflated two accounting concepts, earned revenue and that revenue for which a company was entitled to bill its customers. As stated above, it is a violation of GAAP to recognize revenue before it is earned. *Provenz*, 102 F.3d at 1484. Plaintiffs allege that "defendants recognized millions of dollars in revenue before it was earned and without regard to actual labor costs incurred or total estimated labor costs." Plaintiffs also provided figures allegedly indicating the discrepancy between the revenues Daou recognized and the amount that it was entitled to bill its customers during certain quarters within the class period. Defendants explain that "[r]evenues recognized in excess of amounts billed and project costs are classified as contract work in progress." What defendants' disclosure – that revenue was sometimes being recognized before the customer was billed – does not reveal is that defendants were recognizing revenue *before it was even earned*. An investor would read defendants' disclosure of revenues "recognized" as meaning that the excess revenues recognized were at the very least earned. As plaintiffs allege, that statement was misleading because defendants were allegedly recognizing revenue, before it was earned in violation of GAAP.

Further, systematically recognizing a set amount of revenues before such percentage of labor had been performed and accounting for such premature recognition simply by dumping those amounts in the work-in-progress account could violate other GAAP principles such as "financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit and similar decisions," (citing FASB Statement of Concepts No. 1, ¶ 34), and "financial reporting should be reliable in that it represents what it purports to represent," (citing FASB Statement of Concepts No. 2, ¶¶ 58-59).

Indeed, plaintiffs allege that "[t]he work in progress account was comprised almost entirely of contract amounts Daou had recognized as revenue but for which it was not entitled to bill *because little or no labor had yet taken place* . . . " (emphasis added). If this were the case, then Daou's explanation for its excess revenues may have been misleading if the revenue reported indeed included amounts for which Daou was not entitled to bill *because little or no labor had yet taken place.* In fact, plaintiffs provide one telling example of defendants recognizing revenue before a contract was even signed:

> [D]uring the final weeks of the 3Q97, defendants were desperate to report revenue growth. At the time, according to CW5 [who allegedly had personal knowledge of this project], Daou, led by G. Daou, was in the process of negotiating a multi-million dollar contract with Candler Health Systems. During the final days of 3Q97, all of the equipment for the Candler Health Systems project was ordered and Daou immediately recognized 20% of the contract price, approximately $1-1.5 million, as revenue, before any contract

> was signed. By the following quarter, after the Candler Health Systems project revenues had been reported, Daou still did not have a contract and had incurred no actual labor costs. Daou never received the contract and eventually was forced to sell the equipment at a loss.

Plaintiffs further describe how this allegedly premature recognition affected Daou's financial bottom line:

> Had Daou reported revenue in line with the amount it was entitled to bill customers pursuant to its contracts, actually reflecting contract work done to date, revenue for 3Q97 would have been only $5.9 million, 48% less than publicly reported ($11.3 million). CW13, CW17, and CW 27 confirmed that the dramatic growth in Daou's work in progress account, increasing $5.4 million from 2Q97 to 3Q97, was the result of defendants' premature recognition of revenue.

In addition to pleading the approximate amount by which revenues and earnings were overstated, plaintiffs also provide the dates of some of the related transactions and the identities of the customers and the company employees involved in the transactions. For example, as noted above, plaintiffs described an occurrence with the Centura Health project, which allegedly involved several of the confidential witnesses. CW5 indicated that Daou offered him and two other salaried Field Service employees $100 to come into Daou on the last Saturday of June 1997, unpack and plug in computer equipment ordered for the Centura Health project and immediately record eight hours of labor. CW5 alleged that the purpose of this event "was to justify recognizing 30%-40% of the revenue on the Centura Health project in 2Q97." On another occasion, as noted above, CW5 corroborates other evidence that Daou

recognized 20% of the contract price – $1 to 1.5 million – on the Candler Health project before the contract was even signed. Notably, plaintiffs allege that Daou never received the Candler Health contract.

From these allegations, we conclude that plaintiffs have provided enough information for "a court [to] discern whether the alleged GAAP violations were minor or technical in nature, or whether they constituted widespread and significant inflation of revenue." *See In re McKesson*, 126 F. Supp. 2d at 1273. Certainly, prematurely recognizing millions of dollars in revenue is not minor or technical in nature. Further, the complaint, although largely repetitive in its assertions, indicates that these practices allegedly occurred systematically throughout the class period. We hold, therefore, that these allegations sufficiently state reasons why the reporting statements were misleading and, as an allegation made on information and belief, the facts on which that belief was formed. *See Gompper*, 298 F.3d at 895. These allegations include specific descriptions of how Daou allegedly violated GAAP procedures and, in so doing, misled present and potential investors by artificially inflating Daou's revenues above what should have been reported.

Similarly, we hold that plaintiffs' claims regarding employee training and turnover contain sufficient particularity to support a securities fraud claim. Plaintiffs allege that various defendants made statements indicating that Daou instituted a training program called "Daou University," at which Daou employees were taught technical skills and became certified in computer networking languages and programs. Moreover, plaintiffs contend, in May 1998, D. Daou and McGee represented that Daou had an ongoing program with local universities in San Diego

whereby Daou brought in college students to Daou University to train them in systems and networking. According to plaintiffs, neither Daou University, nor the company's program with local college students, existed. Plaintiffs further assert that defendants misled potential investors by understating employee turnover and attrition.

The district court concluded that these allegations lacked sufficient particularity to be actionable. As to employee attrition, for example, the district court noted:

> The one allegation of any substance, Plaintiffs' contention that employee attrition was actually 40%, not 6.8% as represented by Defendants, does not establish misrepresentation on Defendants' part. Defendants' statements that attrition among *technical* employees was at 6.8% was made in July 1998, and confidential witnesses' statements that the attrition rate for all employees was at 40% was made in the first quarter of 1998.

However, the complaint itself qualifies the allegation of employee turnover by stating that "[e]mployee turnover, especially among Field Service engineers, exceeded 40%," whereas defendants stated that "attrition within the technical ranks of employees was only 6.8%." Such discrepancy between what Daou executives reported and the allegedly true state of affairs of Daou's employ is adequately misleading to state a claim under 10(b).

We therefore disagree with the district court that Daou's alleged misleading statements of employee turnover and lack of training were not sufficiently particularized to state a cause of action under the PSLRA's heightened pleading standards. Plaintiffs provide several accounts of confidential witnesses claiming that "Daou

University" did not in fact exist and that Daou actually had "no in-house training program whatsoever, and according to CW21, the Company was hiring, among others, untrained mechanics and cable pullers as computer technicians, not college graduates." Unlike *In re Vantive*, where the court held insufficient generic allegations of "inadequate training" or "very high salesforce turnover," *see In re Vantive*, 283 F.3d at 1086-87, the complaint here contains sufficiently detailed allegations of misleading statements or omissions regarding Daou's ability to train and retain its employees to state a claim even under the PSLRA's more rigorous standard.

Plaintiffs' allegations regarding Daou's "pipeline" expectations, however, fail to satisfy the PSLRA's requirements. The complaint alleges that Daou misrepresented its "pipeline" expectations, stating that its position was "extremely strong" and "remained healthy and would fuel future earnings growth," that "visibility of future earnings was outstanding," and that the company's "momentum was increasing." Although these projections might have been overly optimistic when made, they do not rise to the level of a material misrepresentation actionable after enactment of the PSLRA:

> Congress enacted the PSLRA to put an end to the practice of pleading "fraud by hindsight." *See e.g., Medhekar v. United States Dist. Ct.*, 99 F.3d 325, 328 (9th Cir. 1996) (holding that Congress intended for complaints under the PSLRA to stand or fall based on the actual knowledge of the plaintiffs rather than information produced by the defendants after the action has been filed).

Silicon Graphics, 183 F.3d at 988. Under the PSLRA's "safe harbor" provisions, plaintiffs must prove that "forward-looking" statements were made with "actual knowledge" that they were false or misleading. *Id.* at 993 (Browning, J., concurring in part and dissenting in part) (quoting 15 U.S.C. §§ 78u-5(c)(1)(B), 77z-2(c)(1)(B)) (internal quotation marks omitted). Plaintiffs allege that Daou sales executives would hold weekly or bi-weekly conference calls with McNeill on the status or outlook of prospective projects, and, based on these calls, McNeill and assistants would prepare a Pipeline Report. The complaint further asserts that "[t]he Pipeline Report contained the arbitrary determination of future business based on fixed percentages of proposed contracts' value." The complaint describes the method by which Daou would determine and report its potential sales revenue to analysts and the market:

> The "revenue" listed in the report and provided to analysts and the market was, according to CW9, automatically set at 20% of a contract's total value if a Daou salesperson had even met with the prospective client to discuss a deal, 50% if Daou had submitted a deal proposal, 70% if Daou had submitted a formal bid on the deal, 90% if Daou "appeared to have won" but the deal was not formally [sic] closed and 100% when the sale was formerly closed. The pipeline figure, despite defendants' representations, did not actually reflect contracts Daou would actually get, and included millions of dollars on projects that Daou had little or no chance of actually doing.

Plaintiffs provide no specific facts, however, to substantiate the speculative claim that Daou had little or no chance of actually obtaining certain contracts. Further,

plaintiffs fail to provide sufficient facts to demonstrate that defendants had actual knowledge that these optimistic statements were false and misleading when made. Therefore, we agree with the district court that these claims are not actionable under section 10(b).

In sum, however, we find that plaintiffs adequately pled fraud as to defendants' alleged misuse of the GAAP protocols and alleged misstatements regarding employee training and turnover to survive a motion to dismiss for failure to state a claim.

2. *Scienter*

Under the PSLRA's new standard, a securities fraud complaint must "state with particularity facts giving rise to a *strong* inference that the defendant acted with the required state of mind." *Gompper*, 298 F.3d at 895 (citing 15 U.S.C. § 78u-4(b)(2) (emphasis added in *Gompper*)); *see also Silicon Graphics*, 183 F.3d at 974 (facts must come closer to demonstrating intent as opposed to mere motive and opportunity). Thus, the complaint must allege that the defendants made false or misleading statements either intentionally or with deliberate recklessness. *See Silicon Graphics*, 183 F.3d at 974. This court considers "whether the total of plaintiffs' allegations, even though individually lacking, are sufficient to create a strong inference that defendants acted with deliberate or conscious recklessness." *Nursing Home*, 380 F.3d at 1230 (quoting *No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. West Holding Corp.*, 320 F.3d 920, 938 (9th Cir. 2003)). In considering whether a strong inference of scienter has been pled, "the court must consider *all* reasonable inferences to be drawn from the allegations,

including inferences unfavorable to the plaintiffs." *Gompper*, 298 F.3d at 897 (emphasis in original).

There are several considerations in determining whether the totality of plaintiffs' allegations leads to a strong inference of scienter. General allegations of defendants' "hands-on" management style, their interaction with other officers and employees, their attendance at meetings, and their receipt of unspecified weekly or monthly reports are insufficient. *In re Vantive*, 283 F.3d at 1087. However, specific admissions from top executives that they are involved in every detail of the company and that they monitored portions of the company's database are factors in favor of inferring scienter in light of improper accounting reports. *See Nursing Home*, 380 F.3d at 1234. Moreover, while scienter cannot be established by publishing inaccurate accounting figures, even when in violation of GAAP, *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1426 (9th Cir. 1994) ("*WOW*"), significant violations of GAAP standards can provide evidence of scienter so long as they are pled with particularity. *In re McKesson*, 126 F. Supp. 2d at 1273; *see also Nursing Home*, 380 F.3d at 1234 ("It is reasonable to infer that the Oracle executives' detail-oriented management style led them to become aware of the allegedly improper revenue recognition of such significant magnitude[.]").

In addition, "the PSLRA neither prohibits nor endorses the pleading of insider trading as evidence of scienter, but requires that the evidence meet the 'strong inference' standard." *Greebel*, 194 F.3d at 197. "Unusual trading or trading at suspicious times or in suspicious amounts by corporate insiders has long been recognized as probative of scienter." *Id.*; *see also Nursing Home*, 380 F.3d at 1231-32 (considering suspicious insider stock sales

as evidence toward meeting the "strong inference" standard). At a minimum, however, "the trading must be in a context where defendants have incentives to withhold material, non-public information, and it must be unusual, well beyond the normal patterns of trading by those defendants." *Greebel*, 194 F.3d at 198.

Plaintiffs allege throughout the complaint that defendants G. Daou, D. Daou, McNeill, and McGee personally directed Daou's recognition of revenue, financial reporting and public statements. They further allege that "[n]ot only were these four defendants the top executives at Daou, but, according to CW23, a former executive assistant to one of the defendants, the Company was run 'top to bottom' by G. Daou and D. Daou, with the assistance of McNeill and McGee." Further, the complaint states that "CW9, a regional Sales Vice President at Daou, confirmed that defendants G. Daou, D. Daou, and McNeill not only made the decision on how much revenue to recognize without regard to any actual percentage of completion, but directed the practice of automatically recognizing revenue upon contract signing and ordering of equipment."

In one example noted above, the complaint describes Daou executives manually adjusting upward POC amounts in what appears to be in violation of GAAP procedure. CW1 confirmed that such practices occurred, and the complaint indicates that G. Daou, D. Daou, McNeill, and "in particular McGee[] presented themselves as knowledgeable about all aspects of the Company's finances, including earnings and revenue recognized under POC accounting." Plaintiffs further allege that "[b]ased on the account of numerous witnesses, all of whom were former members of Daou's executive, Accounting, or Field Services staff, defendants not only knew that the Company's reported financial

results and earnings forecast were based on fraudulent accounting, but personally directed the violations of Daou's stated accounting policy and GAAP in order to artificially inflate revenues"; and "CW8 . . . and CW3 . . . both confirmed that it was known throughout Daou at this time [2Q97] that G. Daou, D. Daou, and McNeill were engaged in improper revenue recognition. . . ."

These specific allegations of direct involvement in the production of false accounting statements and reports are even more probative of scienter than the allegations involved in *Nursing Home*, where this court stated that the top executives' admittedly detail-oriented management style led to a reasonable inference that the top executives were aware of significant accounting irregularities. *See Nursing Home*, 380 F.3d at 1234. Indeed, the facts alleged by plaintiffs lead to an even stronger inference: plaintiffs have alleged with specificity that the top executives actually directed the improper revenue recognition in violation of both GAAP and their own accounting practices.

Plaintiffs also cite suspicious corporate acquisitions and insider stock sales to demonstrate defendants' scienter. They assert that these events demonstrate that defendants "had motive to inflate Daou's stock price and perpetuate the fraudulent scheme and course of business complained of. . . ." The complaint notes that during the class period, Daou acquired 11 companies by exchanging over 6.6 million shares of Daou stock. Plaintiffs present a chart that indicates how many Daou shares "saved" by using artificially inflated stock to purchase the 11 companies. For example, for Daou to purchase INTEGREX Systems Corp. in July 1997, Daou exchanged 700,000 shares of Daou stock valued at $11,400,000; they assert

that had Daou's stock been properly valued, they would have been forced to use 1,476,403 additional shares to make the INTEGREX purchase. All told, the chart indicates that Daou saved 19,642,865 shares of its stock in the 11 acquisitions by using its overvalued stock.

The complaint also highlights that defendants G. Daou, D. Daou, McGee, McNeill, and Moragne, sold a total of 1,477,718 shares during the class period for a total of $30,512,393, and in so doing, they knowingly "profit[ed] from the fraud." Although plaintiffs note that defendants took advantage of the artificially inflated stock prices, interestingly, defendants did not sell at the height of Daou's stock prices; e.g., of the stock G. Daou sold during the class period, he received a maximum price of $22.86 per share, whereas Daou's stock price peaked at $34.375 in September 1997. Moragne, on the other hand, sold 11,408 shares at the highest price among defendants who sold stock during the class period, $31.69 per share in November 1997. Despite the fact that defendants did not capitalize on Daou's peak price per share, plaintiffs nonetheless contend that the sales were made at suspicious moments: "the fact that 98% of all insider sales . . . took place on only two trading days (August 15, 1997 and January 29, 1998) is highly suspect and indicative of coordinated selling among defendants." Plaintiffs contend that the sales correspond perfectly with the "huge increase in the price of Daou stock that immediately followed [defendants'] false statements and reports. . . ." Plaintiffs also note that, in addition to the suspicious insider trading by defendants, other Daou executives as well as defendants' family members "dumped" a grand total of 2.5 million shares of Daou stock during the class period at artificially inflated prices. Another chart in the complaint

explains the percentage of defendants' sales during the class period compared to their total sales through December 31, 2000. Sales by defendants G. Daou, D. Daou, McNeill and Moragne during the class period represented 100% of their total stock sales as of the end of 2000; only defendant McGee sold stock after the close of the class period.

When considered as a whole, plaintiffs' allegations are sufficient to create a strong inference that all defendants except Moragne acted with at least deliberate recklessness. The complaint relays specific information from actual witnesses, albeit unnamed, that defendants knowingly violated GAAP procedures and present more than mere evidence of a motive and opportunity to commit fraud. Although plaintiffs' allegations of Daou's top-to-bottom management hierarchy, defendants' suspicious stock sales, or the corporate acquisitions *alone* would not likely demonstrate defendants' scienter, these plus the complaint's specific allegations of deliberate accounting misfeasance create a strong inference of scienter. *See Nursing Home*, 380 F.3d at 1234 ("Considered separately, Plaintiffs' allegations may not create a strong inference of scienter. However, . . . [w]e find that the totality of the allegations does create a strong inference that Oracle acted with scienter[.]"); *cf. Silicon Graphics*, 183 F.3d at 988 (holding insufficient the plaintiff's "generic" allegations). Unlike in *Silicon Graphics*, this complaint contains sufficient "particularity" and "incriminating facts" to distinguish the allegations from the countless "fishing expeditions" which the PSLRA was designed to deter. *See Silicon Graphics*, 183 F.3d at 988 (citing H.R. Conf. Rep. No. 104-369, at 37).

However, we affirm the district court's dismissal of defendant Moragne as relates to the section 10(b) and Rule 10b-5 claims. The complaint's main allegations to establish scienter against defendant Moragne are suspicious stock sales, and those allegations, as pled in plaintiffs' complaint, do not rise to the level of a strong inference. Importantly, there is nothing to suggest Moragne was involved in the day-to-day operations of Daou, much less heavily involved in the details and personally directing the accounting irregularities. Our affirmance as to Moragne, however, does not imply that suspicious stock sales, by themselves, can never lead to a strong inference. The facts alleged in this complaint simply do not support a strong inference of scienter.

3. *Connection with the Purchase or Sale of a Security*

Plaintiffs have sufficiently alleged a connection between the misrepresentations and the purchase or acquisition of Daou common stock.

4. *Transaction and Loss Causation*

A court must also consider whether the plaintiff has shown some causal connection between the fraud and the securities transaction in question. *The Ambassador Hotel Co. v. Wei-Chuan Inv.*, 189 F.3d 1017, 1026 (9th Cir. 1999); *Levine v. Diamanthuset, Inc.*, 950 F.2d 1478, 1486 (9th Cir. 1991) ("[P]laintiff must establish a connection between the defendant's alleged misrepresentation and the security at issue."). "Deception related to the value or merit of the securities in question has sufficient connection to securities transactions to bring the fraud within

the scope of § 10(b)." *The Ambassador Hotel*, 189 F.3d at 1026 (citation omitted).

The causation requirement can be broken down into two necessary elements: actual cause ("transaction causation") and proximate cause ("loss causation"):

> [I]n an action brought under Rule 10b-5 for material omissions or misstatements, the plaintiff must prove both transaction causation, that the violations in question caused the plaintiff to engage in the transaction, and loss causation, that the misrepresentations or omissions caused the harm.

Id. at 1027 (quoting *Hatrock v. Edward D. Jones & Co.*, 750 F.2d 767, 773 (9th Cir. 1984)). Thus, to prove transaction causation, the plaintiff must show that, but for the fraud, the plaintiff would not have engaged in the transaction at issue; to prove loss causation, the plaintiff must demonstrate a causal connection between the deceptive acts that form the basis for the claim of securities fraud and the injury suffered by the plaintiff. *Id.*; *see also Dura Pharms.*, 125 S.Ct. at 1633 ("[P]laintiff [must] prove that the defendant's misrepresentation (or other fraudulent conduct) proximately caused the plaintiff's economic loss."). A plaintiff is not required to show "that a misrepresentation was the *sole* reason for the investment's decline in value" in order to establish loss causation. *See Robbins v. Koger Props., Inc.*, 116 F.3d 1441, 1447 n. 5 (11th Cir. 1997) (emphasis added). "[A]s long as the misrepresentation is one substantial cause of the investment's decline in value, other contributing forces will not bar recovery under the loss causation requirement" but will play a role "in determining recoverable damages." *Id.*

Here, we conclude that plaintiffs have sufficiently demonstrated defendants' fraud, such that the "[d]eception related to the value or merit of the securities in question" creates a sufficient connection to the securities transactions to bring the fraud within the scope of section 10(b). *See id.* at 1026 (citation omitted). Such fraud in disclosing Daou's financial position would likely suffice to prove transaction causation: but for the fraud, plaintiffs would not have engaged in the transaction at issue. *See id.* at 1027.

As the district court pointed out, however, establishing "loss causation" is a more difficult task, as the district court found that Daou's improper use of the POC method was not linked to the decline in Daou's share price. The court stated:

> It is undisputed that Daou's 3Q98 financial results were dismal, and that this led to the precipitous drop in the Company's stock value. However, in the TAC, Plaintiffs have not adequately been able to link the decline in share price to any purported improper revenue recognition by Defendants. Plaintiffs point to the fact that market analysts questioned whether Defendants had been "cooking" Daou's books after the 3Q98 results were revealed, but this is merely speculation. Notably, the TAC does not allege that there were any negative public statements, announcements or disclosures at the time the stock price dropped that Defendants were engaged in improper accounting practices.

In other words, if the improper accounting did not lead to the decrease in Daou's stock price, plaintiffs' reliance on the improper accounting in acquiring the stock would not be sufficiently linked to their damages.

An independent assessment of the TAC, however, indicates that the price of Daou's stock fell precipitously after defendants began to reveal figures showing the company's true financial condition. On August 13, 1998, Daou's stock was trading at $18.50 per share. The TAC alleges that "beginning in August 1998, defendants revealed that Daou's operating expenses and margins were deteriorating and, on October 28, 1998, defendants revealed that Daou had dramatically missed its projected 3Q98 earnings and would have to report a loss of $0.17 a share." Notably, the TAC alleges that "Defendants further revealed that the Company's rapidly escalating work in progress account represented over $10 million in unbilled receivables – *the direct result of prematurely recognizing revenue.*" (emphasis added). Later, the TAC alleges that, prior to the August 13, 1998 disclosure, "[d]efendants failed to disclose the actual figures to analysts to conceal the fact that Daou's operating earnings and margins were deteriorating as a result of prematurely and improperly recognizing revenue." Finally, as the district court also noted, the TAC anonymously quotes an analyst who allegedly stated, "[w]hen you say one thing on the conference call and report something different on the 10-Q, that raises concern. . . . *You have got to question whether they are manufacturing earnings.*"

Plaintiffs allege that these disclosures of Daou's true financial health, the result of prematurely recognizing revenue before it was earned, led to a "dramatic, negative effect on the market, causing Daou's stock to decline to $3.25 per share, a staggering 90% drop from the Class Period high of $34.375 *and a $17 per share drop from early August 1998.*" (emphasis added). Indeed, the TAC alleges that "[f]ollowing these revelations, defendants conceded

that Daou was moving its business practice away from fixed-price contracts with revenue recognized on a percentage of completion basis to charging on a time and expense basis." Finally, the TAC alleges that "Daou's stock price has never recovered and the Company has never been able to match the artificially inflated revenues reported during the Class Period."

We conclude that the foregoing allegations, if assumed true, are sufficient to provide Daou with some indication that the drop in Daou's stock price was causally related to Daou's financial misstatements reflecting its practice of prematurely recognizing revenue before it was earned. *See Dura Pharms.*, 125 S.Ct. at 1634 (requiring "a plaintiff who has suffered an economic loss to provide a defendant with some indication of the loss and the causal connection that the plaintiff has in mind"). We note that, as the TAC currently reads, at the time when Daou began to reveal its true financial health in August 1998, its stock was trading at $18.50 per share and not at the class high of $34.375. The TAC does not allege any revelation of Daou's true financial health prior to August 1998. Thus, as the TAC reads now, any loss suffered between $34.375 and $18.50 cannot be considered causally related to Daou's allegedly fraudulent accounting methods because before the revelations began in August 1998, the true nature of Daou's financial condition had not yet been disclosed.

5. *Economic Loss*

Plaintiffs' economic loss was not that they purchased stock at inflated prices; rather, their economic loss was the decline in their stock value that was the direct result of Daou's misrepresentations. *See Dura Pharms.*, 125 S.Ct.

at 1631-32. Here, the TAC's assertions of a steep drop in Daou's stock price following the revelation of Daou's true financial situation are sufficient to enable the complaint to survive a motion to dismiss under Federal Rule of Civil Procedure 12(b)(6).

b. *Plaintiffs' 1933 Securities Act section 11 claim*

Unlike section 10(b), section 11 of the 1933 Securities Act creates a private remedy for any purchaser of a security if "any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading." 15 U.S.C. § 77k(a). "The plaintiff in a § 11 claim must demonstrate (1) that the registration statement contained an omission or misrepresentation, and (2) that the omission or misrepresentation was material, that is, it would have misled a reasonable investor about the nature of his or her investment." *In re Stac Elecs. Sec. Litig.*, 89 F.3d 1399, 1403-04 (9th Cir. 1996) ("*In re Stac*") (citation and internal quotation marks omitted). "No scienter is required for liability under § 11; defendants will be liable for innocent or negligent material misstatements or omissions." *Id.* (citing *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983)).

Although section 11 does not contain an element of fraud, a plaintiff may nonetheless be subject to Rule 9(b)'s particularity mandate if his complaint "sounds in fraud":

> [T]he plaintiff may allege a unified course of fraudulent conduct and rely entirely on that course of conduct as the basis of a claim. In that event, the claim is said to be "grounded in fraud"

> or to "sound in fraud," and the pleading of that claim as a whole must satisfy the particularity requirement of Rule 9(b).

Vess, 317 F.3d at 1103-04; *see also In re Stac*, 89 F.3d at 1404-05 ("We now clarify that the particularity requirements of Rule 9(b) apply to claims brought under Section 11 [of the 1933 Securities Act] when, as here, they are grounded in fraud.").

In a case where fraud is not an essential element of a claim, only allegations of fraudulent conduct must satisfy the heightened pleading requirements of Rule 9(b). *Vess*, 317 F.3d at 1105. "Allegations of non-fraudulent conduct need satisfy only the ordinary notice pleading standards of Rule 8(a)." *Id.* As the Fifth Circuit wrote:

> Where averments of fraud are made in a claim in which fraud is not an element, an inadequate averment of fraud does not mean that no claim has been stated. The proper route is to *disregard* averments of fraud not meeting Rule 9(b)'s standard and then ask whether a claim has been stated.

Id. (citing *Lone Star Ladies Inv. Club v. Schlotzsky's Inc.*, 238 F.3d 363, 368 (5th Cir. 2001) ("*Lone Star*")) (emphasis added in *Vess*). As the Eighth Circuit elaborated:

> The only consequence of a holding that Rule 9(b) is violated with respect to a § 11 claim would be that any allegations of fraud would be *stripped from the claim*. The allegations of innocent or negligent misrepresentation, which are at the heart of a § 11 claim, would survive.

Id. (citing *Carlon v. Thaman* (*In re NationsMart Corp. Sec. Litig.*), 130 F.3d 309, 315 (8th Cir. 1997)) (emphasis added

in *Vess*). "Thus, if particular averments of fraud are insufficiently pled under Rule 9(b), a district court should 'disregard' those averments or 'strip' them from the claim. The court should then examine the allegations that remain to determine whether they state a claim." *Id.*

A district court need not rewrite a deficient complaint however. *Lone Star*, 238 F.3d at 368. Rule 9(b) may prove fatal to 1933 Securities Act claims "grounded in fraud" when the complaint makes a "wholesale adoption" of the securities fraud allegations for purposes of the Securities Act claims. *Id.* (citations, internal quotation marks, and emphasis omitted). In such cases,

> a district court is not required to sift through allegations of fraud in search of some "lesser included" claim of strict liability. It may dismiss. If it does so, it should ordinarily accept a proffered amendment that either pleads with the requisite particularity or drops the defective allegations and still states a claim.

Id. at 368-69.

Here, plaintiffs' TAC "sounds in fraud." Notably, the first sentence of the complaint introduces the action as one "brought on behalf of a class of purchasers of Daou Systems, Inc. . . . common stock [during the class period], seeking damages *resulting from a fraudulent scheme and course of business by defendants*, which harmed [such] purchasers." (emphasis added). Thereafter, the complaint goes on to allege myriad misrepresentations made by defendants, of which defendants had full knowledge, which induced plaintiffs' reliance, and which caused plaintiffs damages. The complaint fully incorporates all allegations previously averred in the complaint for purposes of all their

claims. Because the complaint makes a "wholesale adoption" of the securities fraud allegations for purposes of the Securities Act claims, this court need not "sift through allegations of fraud in search of some 'lesser included' claim of strict liability"; indeed, plaintiffs here never rely on such conduct as negligence or mistake in stating their claims. *Cf. Vess*, 317 F.3d at 1105-06. Thus, all of plaintiffs' claims, whether including an element of fraud or not, must satisfy the heightened pleading standard set out in Rule 9(b). *See In re Stac*, 89 F.3d at 1404-05.

To survive dismissal, therefore, plaintiffs must demonstrate, with particularity, "(1) that the registration statement contained an omission or misrepresentation, and (2) that the omission or misrepresentation was material, that is, it would have misled a reasonable investor about the nature of his or her investment." *In re Stac*, 89 F.3d at 1403-04 (citation and internal quotation marks omitted). Here, as discussed above, plaintiffs have shown with sufficient particularity that defendants engaged in materially false revenue reporting in the various statements disclosed during the class period. Thus, plaintiffs' section 11 claims against all defendants, including defendant Moragne, survive dismissal under Rule 12(b)(6).

c. *Plaintiffs' claims under section 12(a)(2)*

Section 12(a)(2) of the 1933 Securities Act imposes civil liability on any person for use of any instrumentality of interstate commerce to offer or sell securities by means of a prospectus or oral communication that includes "an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were

made, not misleading. . . ." 15 U.S.C. § 77*l*(a)(2). To establish liability under section 12(a)(2), a plaintiff must allege that the defendants did more than simply urge another to purchase a security; rather, the plaintiff must show that the defendants solicited purchase of the securities for their own financial gain:

> The person who gratuitously urges another to make a particular investment decision is not, in any meaningful sense, requesting value in exchange for his suggestion or seeking the value the titleholder will obtain in exchange for the ultimate sale. The language and purpose of § 12(1) suggest that liability extends only to the person who successfully solicits the purchase, *motivated at least in part by a desire to serve his own financial interests or those of the securities owner.* If he had such a motivation, it is fair to say that the buyer "purchased" the security from him. . . .

Pinter v. Dahl, 486 U.S. 622, 647 (1988) (emphasis added).

The purchaser must also demonstrate damages to recover under section 12. Because section 12 provides that a person who sells a security through use of material misstatements or omissions "shall be liable . . . to the person purchasing such security from him . . . [for] the consideration paid for such security with interest thereon, less the amount of any income received thereon, . . . or for damages if he no longer owns the security," 15 U.S.C. § 77*l*(a), there can be no recovery unless the purchaser has suffered a loss. *In re Broderbund/Learning Co. Sec. Litig.*, 294 F.3d 1201, 1205 (9th Cir. 2002). "That is to say, what the purchaser is entitled to is 'a return of the consideration paid, reduced by the amount realized when he sold the security and by any "income received" on the security.'" *Id.* (citing

Randall v. Loftsgaarden, 478 U.S. 647, 656 (1986) (citation omitted)). Causation, however, is not a necessary element of a prima facie case under section 12 of the Securities Act. *See Casella v. Webb*, 883 F.2d 805, 808 & n.8 (9th Cir. 1989) (holding that if the alleged misrepresentations are material, a plaintiff is entitled to recovery whether or not the misrepresentations caused the alleged damage).

The district court failed to reach the issue of whether Daou and the individual defendants were "directly involved" in the actual solicitation of a securities purchase because it had determined that "Plaintiffs' 12(a)(2) claim necessarily fails for lack of adequate allegations that Defendants made any false or misleading statements or omissions of material fact." Because we hold that plaintiffs adequately averred material misrepresentations on the part of defendants' statements in their various periodic disclosures, the district court must revisit the remaining elements of plaintiffs' section 12(a)(1) claim to determine whether they are sufficient to survive dismissal under Rule 12(b)(6).

d. *Plaintiffs' claims under sections 15(a) of the 1933 Securities Act and 20(a) of the 1934 Exchange Act*

Section 15(a) of the 1933 Securities Act imposes joint and several liability upon every person who controls any person liable under sections 11 or 12. 15 U.S.C. § 77o. Such section provides:

> Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls

> any person liable under sections 77k or 77*l* of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

Id.

Similarly, section 20(a) of the 1934 Exchange Act provides:

> Every person who, directly or indirectly, controls any person liable under any provision of [chapter 2B] or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. § 78t(a).

Because the district court did not find that Daou or the individual defendants had engaged in anything but "an exercise of Defendants' business judgment," it also rejected plaintiffs' contention that defendants should be liable under sections 15(a) or 20(a). Again, because we conclude that plaintiffs have adequately set forth a claim of accounting fraud, the district court must reassess the viability of plaintiffs' sections 15 and 20 claims as well.

CONCLUSION

Plaintiffs' complaint, although lengthy and often repetitive, states a sufficiently particularized claim for accounting fraud under the heightened pleading standards of the PSLRA. Accordingly, we need not reach plaintiffs' request for leave to amend nor defendants' request for attorney's fees. The case is remanded to the district court for further proceedings consistent with this opinion. The parties shall bear their own costs.

AFFIRMED in part; REVERSED in part and REMANDED.

APPENDIX B

FOR PUBLICATION

UNITED STATES COURT OF APPEALS, FOR THE NINTH CIRCUIT

In re: DAOU SYSTEMS, INC., SECURITIES LITIGATION,	
GREG SPARLING; EUGENE KRABBENHOFT; PATRICK DE KRUYFF, Esq.; ROBERT ZARETSKY; ROD FORD; THOMAS V. HAGMAN; RICHARD W. WALSH; RICHARD TORIBIO; PAUL RABIN, *Plaintiffs-Appellants*, v. GEORGES DAOU; DANIEL DAOU; FRED MCGEE; ROBERT MCNEILL; JOHN MORAGNE; DAOU SYSTEMS, INC., *Defendants-Appellees*.	No. 02-56989 D.C. No. CV-98-01537-L/CGA

In Re: DAOU SYSTEMS, INC., SECURITIES LITIGATION,	
GREG SPARLING; EUGENE KRABBENHOFT; PATRICK DE KRUYFF, Esq.; ROBERT ZARETSKY; ROD FORD; THOMAS V. HAGMAN; RICHARD W. WALSH; RICHARD TORIBIO; PAUL RABIN, *Plaintiffs-Appellants*, v. GEORGES DAOU; DANIEL DAOU; FRED MCGEE; ROBERT MCNEILL;	No. 02-57018 D.C. No. CV-98-01537-L/CGA OPINION

JOHN MORAGNE;

Defendants,

and

DAOU SYSTEMS, INC.,

Defendant-Appellant.

Appeal from the United States District Court
for the Southern District of California
M. James Lorenz, District Judge, Presiding

Argued and Submitted
February 12, 2004 – Pasadena, California

Filed February 2, 2005.

Before: Betty B. Fletcher, Harry Pregerson, and
Melvin Brunetti, Circuit Judges.

Opinion by Judge Brunetti

COUNSEL

Eric A. Isaacson, San Diego, California, for the plaintiffs-appellants/appellees.

Michael P. McCloskey, San Diego, California, for the defendants-appellees/appellants.

OPINION

BRUNETTI, Circuit Judge:

Plaintiffs, a class of former Daou Systems, Inc. ("Daou") investors who purchased Daou common stock between February 13, 1997 and October 28, 1998, allege that defendants Daou, Chief Executive Officer and Chairman of the Board Georges Daou ("G.Daou"), President and

Director Daniel Daou ("D.Daou"), Chief Financial Officer and Senior Vice President Fred McGee, Chief Operating Officer and Executive Vice President Robert McNeill, and Director John Moragne systematically and fraudulently violated the Generally Accepted Accounting Principles ("GAAP") in order to artificially inflate the price of Daou's stock. Plaintiffs also allege that they incurred substantial personal losses due to their respective purchases of Daou stock at fraudulently inflated prices. The district court, on several occasions, determined that plaintiffs had failed to state sufficiently particularized claims under the 1933 Securities Act and the 1934 Exchange Act and thrice granted plaintiffs leave to amend. Plaintiffs now appeal the district court's dismissal of their Third Amended Complaint ("TAC") with prejudice. Defendants also cross-appeal the district court's failure to consider, *sua sponte*, whether to impose sanctions against plaintiffs and plaintiffs' attorneys.

FACTS[1] AND PROCEEDINGS BELOW

Daou created, implemented, and supported computer networking systems for use in the healthcare field. Beginning with its first public offering in February 1997, Daou represented itself as a technologically astute company able to keep pace with the ever-changing medical field. For seven consecutive quarters, Daou reported "record" growing revenues and stated that the company's earnings per share ("EPS") had and would exceed market expectations. Daou allegedly touted "spectacular" results and "strong

[1] The following facts are taken from plaintiffs' third amended complaint and will be assumed true for purposes of the within review. *See Gompper v. VISX, Inc.*, 298 F.3d 893, 895 (9th Cir.2002).

growth" while also reporting successful employee retention as well as an "extremely strong pipeline position."

Plaintiffs contend that Daou fraudulently inflated the price of its stock by reporting revenues before they were earned, in violation of GAAP. The company employed an accounting method known as the percentage-of-completion ("POC") method, which is used primarily to account for progress on long-term projects. Under this method, revenue from these projects could only be recognized based on the percentage of labor costs incurred to date compared to the total estimated labor costs for the project. Plaintiffs allege, however, that defendants would prematurely recognize revenue in contravention of the POC method. For example, plaintiffs allege that defendants systematically, without regard to labor costs incurred or estimated, recognized 20% of the contract revenue immediately upon signing products contracts, 40% of the contract revenue immediately after the equipment to be installed was ordered, and 50%-60% of the contract revenue as soon as the equipment was configured and tested. Plaintiffs contend that because of such artificial inflation of the price of Daou stock, Daou was able to acquire eleven companies, and Daou executives and their respective family members were able to sell nearly 2.5 million shares for a total of $54.67 million in improper proceeds. Plaintiffs also allege that to their detriment they purchased their Daou shares during the class period at artificially inflated prices and that, had they been aware of Daou's true financial results and condition, they would not have purchased their shares, or at least not at the prices paid.

Defendants counter that their method of accounting did not violate GAAP or their own stated policy, as they revealed in various disclosures that

> [c]ontract revenue for the development and implementation of network solutions is recognized on the percentage-of-completion method with progress to completion measured by labor costs incurred to date compared to total estimated labor costs. . . . *Revenues recognized in excess of amounts billed and project costs are classified as contract work in progress.*

(emphasis added). The district court agreed and determined that plaintiffs had failed to expose any financial tomfoolery on the part of Daou in its execution of the POC accounting method:

> Plaintiffs appear [to] argue that, because there was a variance between recognized and earned revenue, Defendants must have been engaged in accounting fraud. Their allegations that the funds in the work in progress account represented improperly recognized revenue are conclusory and appear to result from circular logic. Plaintiffs simply have not shown that recognizing unearned revenue and earmarking it for the work in progress account is anything but an exercise of Defendants' business judgment.

Such failure, the court concluded, proved fatal to plaintiffs' remaining claims, as, for example, if Daou's statements were not false and misleading, then defendants did nothing requiring an assessment of their scienter in making them. The court consequently dismissed plaintiffs' TAC with prejudice, and this appeal followed.

DISCUSSION

I. *Standard of Review*

We review dismissals under Federal Rules of Civil Procedure 9(b) and 12(b)(6) de novo. *Vess v. Ciba-Geigy Corp. USA*, 317 F.3d 1097, 1102 (9th Cir. 2003) (citations omitted). "[W]e accept the plaintiffs' allegations as true and construe them in the light most favorable to plaintiffs." *Gompper*, 298 F.3d at 895 (citations omitted). However, "[c]onclusory allegations of law and unwarranted inferences are insufficient to defeat a motion to dismiss for failure to state a claim." *In re VeriFone Sec. Litig.*, 11 F.3d 865, 868 (9th Cir. 1993) (citations omitted). "Dismissal without leave to amend is improper unless it is clear, upon de novo review, that the complaint could not be saved by any amendment." *Gompper*, 298 F.3d at 898 (citation and internal quotations omitted).

II. *Federal Securities Law*

Plaintiffs' TAC asserts five claims for relief, alleging (1) violation of section 10(b) and Rule 10b-5 of the 1934 Exchange Act against all defendants; (2) violation of section 20(a) of the 1934 Exchange Act against certain defendants; (3) violation of section 11 of the 1933 Securities Act against certain defendants; (4) violation of section 12(a)(2) of the 1933 Securities Act against certain defendants; and (5) violation of section 15 of the 1933 Securities Act against certain defendants.

a. *Section 10(b) of the Exchange Act of 1934*

Section 10(b) of the Exchange Act of 1934, 15 U.S.C. § 78j(b), makes it unlawful "for any person . . . [t]o use or

employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe[.]" SEC Rule 10b-5, promulgated under the authority of section 10(b), in turn, provides:

> It shall be unlawful for any person . . .
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5. The elements of a Rule 10b-5 claim, therefore, are: (1) a misrepresentation or omission of a material fact, (2) scienter, (3) causation, (4) reliance, and (5) damages. *See Binder v. Gillespie*, 184 F.3d 1059, 1063 (9th Cir. 1999); *The Ambassador Hotel v. Wei-Chuan Inv.*, 189 F.3d 1017, 1025 (9th Cir. 1999) (citation omitted); *Paracor Finance, Inc. v. General Elec. Capital Corp.*, 96 F.3d 1151, 115 (9th Cir. 1996). The causation element requires a showing of both actual cause ("transaction causation") and proximate cause ("loss causation"). *The Ambassador Hotel*, 189 F.3d at 1025.

It is well established that claims brought under Rule 10b-5 and section 10(b) must meet the particularity requirements of Federal Rule of Civil Procedure 9(b). *See*

Semegen v. Weidner, 780 F.2d 727, 729, 734-35 (9th Cir. 1985). Rule 9(b) states that "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally."

Further, the enactment of the Private Securities Litigation Reform Act ("PSLRA") in 1995 significantly altered pleading requirements in private securities fraud litigation by amending the 1934 Exchange Act to require that a complaint "plead with particularity both falsity and scienter." *Gompper*, 298 F.3d at 895 (quoting *Ronconi v. Larkin*, 253 F.3d 423, 429 (9th Cir. 2001)); *see also Nursing Home Pension Fund, Local 144 v. Oracle Corp.*, 380 F.3d 1226, 1230 (9th Cir. 2004). A securities fraud complaint must now "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." *Gompper*, 298 F.3d at 895 (quoting 15 U.S.C. § 78u-4(b)(1)).

The complaint must also "state with particularity facts giving rise to a *strong* inference that the defendant acted with the required state of mind." *Id.* (quoting 15 U.S.C. § 78u-4(b)(2) (emphasis added in *Gompper*)); *see also In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 974 (9th Cir. 1999) ("*Silicon Graphics*") (facts must come closer to demonstrating intent as opposed to mere motive and opportunity). The stricter standard for pleading scienter naturally results in a stricter standard for pleading falsity, because " 'falsity and scienter in private securities fraud cases are generally strongly inferred from the

same set of facts,' and the two requirements may be combined into a unitary inquiry under the PSLRA." *In re Vantive Corp. Sec. Litig.*, 283 F.3d 1079, 1091 (9th Cir. 2002) ("*In re Vantive*") (*quoting Ronconi*, 253 F.3d at 429). Thus, the complaint must allege that the defendants made false or misleading statements either intentionally or with deliberate recklessness. *Silicon Graphics*, 183 F.3d at 974.

b. *Reliance on Confidential Witnesses*

Because many of plaintiffs' allegations come from accounts of confidential witnesses, their use in satisfying the PSLRA's standard of particularity must be addressed. This circuit in *Silicon Graphics* cautioned about the use of unnamed sources in stating that "[i]t is not sufficient for a plaintiff's pleadings to set forth a belief that certain unspecified sources will reveal, after appropriate discovery, facts that will validate her claim." *Silicon Graphics*, 183 F.3d at 985. Instead, to meet this particularity requirement for personal sources of information, this circuit has applied the Second Circuit's standard that "personal sources of information relied upon in a complaint should be 'described in the complaint with sufficient particularity to support the probability that a person in the position occupied by the source would possess the information alleged.'" *Nursing Home*, 380 F.3d at 1233 (quoting *Novak v. Kasaks*, 216 F.3d 300, 314 (2d Cir. 2000)). Where plaintiffs rely on both confidential witnesses and on other facts, "they need not name their sources as long as the latter facts provide an adequate basis for believing that the defendants' statements were false." *Novak*, 216 F.3d at 314; *see also Silicon Graphics*, 183 F.3d at 985 (complaint should include "adequate corroborating details").

The First Circuit has also adopted *Novak's* approach of "look[ing] at all of the facts alleged to see if they 'provide an adequate basis for believing that the defendants' statements were false.'" *In re Cabletron Systems, Inc.*, 311 F.3d 11, 29 (1st Cir. 2002) (citing *Novak*, 216 F.3d at 314). The First Circuit added that this approach "involves an evaluation, *inter alia*, of the level of detail provided by the confidential sources, the corroborative nature of the other facts alleged (including from other sources), the coherence and plausibility of the allegations, the number of sources, the reliability of the sources, and similar indicia." *Id.* at 29-30.

This circuit's approach does not necessarily require a plaintiff to name his or her confidential witnesses. However, this circuit does strictly adhere to the PSLRA's mandate that the complaint "state with particularity all facts on which [a] belief is formed," and in so doing, requires that a plaintiff reveal "the sources of her information." *Silicon Graphics*, 183 F.3d at 985 (citation and internal quotation marks omitted). It is by this circuit's adoption of the Second Circuit's standard for evaluating personal sources of information, augmented by the First Circuit's suggested criteria for assessing reliability of confidential witnesses, that plaintiffs' complaint here should be evaluated. So long as plaintiffs reveal with particularity the sources of their information, the complaint will survive under the PSLRA. Naming sources is unnecessary so long as the sources are described "with sufficient particularity to support the probability that a person in the position occupied by the source would possess the information alleged" and the complaint contains "adequate corroborating details." *See Nursing Home*, 380

F.3d at 1233 (citation and internal quotation marks omitted); *Silicon Graphics*, 183 F.3d at 985.

Plaintiffs here describe the confidential witnesses with a large degree of specificity. Plaintiffs number each witness and describe his or her job description and responsibilities. In some instances, plaintiffs provide the witnesses' exact title and to which Daou executive the witness reported. For example, plaintiffs describe Confidential Witness #6 as follows: "Confidential Witness #6 ("CW6") is a former Daou executive who worked in the Finance Department. CW6 dealt with audit issues, Security and Exchange ("SEC") reporting and budget matters. As such, CW6 was familiar with Daou's process of collecting project cost information. CW6 reported to defendant McGee." Similarly, plaintiffs describe Confidential Witness # 9 as follows: "Confidential Witness 9 ("CW9") is a former Daou Regional Vice President of Sales. As Vice President of Sales, CW9 was responsible for reporting weekly or bi-weekly sales information, such as sales status/backlog and forecast/pipeline information, to Daou's Vice Presidents and corporate officers." Given the specificity of plaintiffs' descriptions of their confidential witnesses, we hold that plaintiffs have sufficiently met the PSLRA's requirements for confidential witnesses. We next determine whether plaintiffs have sufficiently pled the elements of a Rule 10b-5 claim in light of the PSLRA's heightened pleading standards.

1. *Material Misrepresentations or Omissions*

If "[p]roperly pled, overstating of revenues may state a claim for securities fraud, as under GAAP, 'revenue must be *earned* before it can be recognized.'" *Hockey v. Medhekar*,

30 F.Supp.2d 1209, 1216 (N.D. Cal. 1998) (quoting *Provenz v. Miller*, 102 F.3d 1478, 1484 (9th Cir. 1996)) (emphasis in original). "To properly state a claim for accounting fraud, plaintiffs must 'plead facts' sufficient to support a conclusion that [d]efendant [] prepared the fraudulent financial statements and that the alleged financial fraud was material." *In re Peerless Systems, Corp. Sec. Litig.*, 182 F. Supp. 2d 982, 991 (S.D. Cal. 2002) (citations omitted) (alterations in original).

Violations of GAAP standards can also provide evidence of scienter. *Id.* (citing *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 203 (1st Cir. 1999)); *see also In re McKesson HBOC, Inc. Sec. Litig.*, 126 F. Supp. 2d 1248, 1273 (N.D. Cal. 2000) ("*In re McKesson*") ("[W]hen significant GAAP violations are described with particularity in the complaint, they may provide powerful indirect evidence of scienter. After all, books do not cook themselves."). To support even a reasonable inference of scienter, much less a strong inference, "the complaint must describe the violations with sufficient particularity; 'a general allegation that the practices at issue resulted in a false report of company earnings is not a sufficiently particular claim of misrepresentation.'" *Greebel*, 194 F.3d at 203-04 (quoting *Gross v. Summa Four, Inc.*, 93 F.3d 987, 996 (1st Cir. 1996), *superseded by statute on other grounds as recognized in Greebel*, 194 F.3d at 197 ("strong" inference rather than "reasonable" inference now required for scienter)).

When pleading irregularities in revenue recognition, plaintiffs should allege "(1) 'such basic details as the approximate amount by which revenues and earnings were overstated'; (2) 'the products involved in the contingent transaction'; (3) 'the dates of any of the transactions'; or (4) 'the identities of any of the customers or [company]

employees involved in the transactions.'" *In re McKesson*, 126 F. Supp. 2d at 1273 (quoting *Greebel*, 194 F.3d at 204) (alteration in *McKesson*). Plaintiffs need not allege each of those particular details, *see Greebel*, 194 F.3d at 204, but they must allege enough information so that "a court can discern whether the alleged GAAP violations were minor or technical in nature, or whether they constituted widespread and significant inflation of revenue." *In re McKesson*, 126 F. Supp. 2d at 1273.

Plaintiffs here contend that defendants systematically reported revenue, before it was earned in violation of GAAP. For example, they assert that Daou, "without regard to labor costs incurred or estimated," recognized 20% of the contract revenue immediately upon signing products contracts, 40% of the contract revenue immediately after the equipment to be installed was ordered, and 50%-60% of the contract revenue as soon as the equipment was configured and tested. Moreover, plaintiffs assert that for one contract, the Centura Health project, certain Field Services personnel were told that they would receive $100 each if they would go into Daou's San Diego warehouse, plug in and turn on certain computers, and, in turn, bill eight hours of work. One confidential witness stated that he never received the $100, and when he inquired about the payment, he was told to "forget it ever happened." The only rationale for such occurrence, according to the confidential witness, was so Daou could prematurely recognize revenue on the Centura Health project.

Similar allegations were made in *Gross*, 93 F.3d at 995-96, *superseded by statute on other grounds.* The plaintiff in *Gross* asserted that Summa Four prematurely recognized revenue upon receipt of orders rather than on shipment of products, a practice that, in turn, allowed

Summa Four to overstate significantly its revenues and earnings during the class period. *Id.* at 995. Gross substantiated such allegations by highlighting certain statements made by Summa Four executives at a board meeting indicating their intention to recognize $4.7 million in late-quarter earnings from the receipt of newly acquired orders, despite the fact that Summa Four generally required twelve to twenty weeks to fulfill such orders. *Id.* at 995-96. Board minutes also revealed that Summa Four's chief financial officer was working on a new "revenue recognition policy" that was to be "more formalized and somewhat more restrictive" than its previous policy. *Id.* at 996.

Although such assertions gave the court "pause," the court nonetheless held that Gross's complaint had not satisfied Rule 9(b)'s heightened pleading standards. *Id.* "A general allegation that the practices at issue resulted in a false report of company earnings is not a sufficiently particular claim of misrepresentation to satisfy Rule 9(b)." *Id.* (citation and internal brackets omitted). The court determined that Gross had failed to allege any particulars to support his general allegation of inflated earnings through the use of improper accounting methods. "Specifically, he has not alleged the amount of the putative overstatement or the net effect it had on the company's earnings." *Id.* The court cited a number of cases in support of this conclusion, including *Shushany v. Allwaste, Inc.*, 992 F.2d 517, 522 (5th Cir. 1993) (allegation that company had adjusted the accounting of its inventory to inflate revenues and earnings does not sufficiently plead fraud where complaint does not explain, *inter alia*, how the adjustments affected the company's financial statements and whether they were material in light of the company's

overall financial position), *Roots Partnership v. Lands' End, Inc.*, 965 F.2d 1411, 1419 (7th Cir. 1992) (allegation that company "failed to establish adequate reserves for its excessive and outdated inventory" does not satisfy Rule 9(b) where investor does not allege "what the reserves were or suggest how great the reserves should have been"), and *Cohen v. Koenig*, 25 F.3d 1168, 1173 (2d Cir. 1994) (fraud pled with sufficient particularity by setting out representations made, what financial figures were given, and what the alleged true financial figures were).

The case law indicates, therefore, that although overstatement of revenues in violation of GAAP may support a plaintiff's claim of fraud, the plaintiff must show with particularity how the adjustments affected the company's financial statements and whether they were material in light of the company's overall financial position. The district court here determined that plaintiffs failed to make such a showing, noting that "despite an exhaustive search of the TAC, the Court was unable to locate and identify any allegations quantifying and contrasting the revenue Defendants *actually* recognized under the POC method and the revenue Defendants *should have* recognized if they had properly applied the POC method" (emphasis in original). "This information," the court stated, "is essential to surviving a motion to dismiss in this context." Moreover, the court noted, "Plaintiffs simply have not shown that recognizing unearned revenue and earmarking it for the work in progress account is anything but an exercise of Defendants' business judgment."

Upon independent review of plaintiffs' complaint, however, we find at least some specific allegations of how the adjustments affected the company's financial statements and whether they were material in light of the

company's overall financial position. The complaint alleges myriad observations of accounting misfeasance (e.g., alleged manipulation of the books), and at least some of such allegations reveal that the amount of revenue Daou formally recognized was completely unrelated to the amount of labor incurred to date. According to Daou's stated method of revenue recognition – the POC method – Daou was to recognize revenue based on the percentage of labor costs incurred to date compared to the total estimated labor costs for the project. However, plaintiffs allege, and confidential witnesses corroborate, that

> Vice Presidents Ringwall and Mirabile would print out the ManFact reports containing actual labor and percent completion submitted by project managers, for the current month and quarter. According to CW3, CW4, CW7 and CW16, the ManFact data was compiled into a Monthly Project Report which was sent to G. Daou, D. Daou, McGee, and McNeill at the close of each month and quarter. . . . Based on the comprehensive Monthly Project Report. G. Daou, D. Daou, McNeill and McGee would adjust upward the percent of completion for projects.

If plaintiffs can in fact prove such intentional manipulation of the accounting principles, they will have shown that Daou's public statements regarding recognized revenue were materially misleading.

Moreover, it appears that the district court conflated two accounting concepts, earned revenue and that revenue for which a company was entitled to bill its customers. As stated above, it is a violation of GAAP to recognize revenue before it is earned. *Provenz*, 102 F.3d at 1484. Plaintiffs allege that "defendants recognized millions of dollars

in revenue before it was earned and without regard to actual labor costs incurred or total estimated labor costs." Plaintiffs also provided figures allegedly indicating the discrepancy between the revenues Daou recognized and the amount that it was entitled to bill its customers during certain quarters within the class period. Defendants explain that "[r]evenues recognized in excess of amounts billed and project costs are classified as contract work in progress." What defendants' disclosure – that revenue was sometimes being recognized before the customer was billed – does not reveal is that defendants were recognizing revenue *before it was even earned.* An investor would read defendants' disclosure of revenues "recognized" as meaning that the excess revenues recognized were at the very least earned. As plaintiffs allege, that statement was misleading because defendants were allegedly recognizing revenue, before it was earned in violation of GAAP.

Further, systematically recognizing a set amount of revenues before such percentage of labor had been performed and accounting for such premature recognition simply by dumping those amounts in the work-in-progress account could violate other GAAP principles such as "financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit and similar decisions," (citing FASB Statement of Concepts No. 1, ¶ 34), and "financial reporting should be reliable in that it represents what it purports to represent," (citing FASB Statement of Concepts No. 2, ¶¶ 58-59).

Indeed, plaintiffs allege that "[t]he work in progress account was comprised almost entirely of contract amounts Daou had recognized as revenue but for which it was not entitled to bill *because little or no labor had yet*

taken place . . . " (emphasis added). If this were the case, then Daou's explanation for its excess revenues may have been misleading if the revenue reported indeed included amounts for which Daou was not entitled to bill *because little or no labor had yet taken place.* In fact, plaintiffs provide one telling example of defendants recognizing revenue before a contract was even signed:

> [D]uring the final weeks of the 3Q97, defendants were desperate to report revenue growth. At the time, according to CW5 [who allegedly had personal knowledge of this project], Daou, led by G. Daou, was in the process of negotiating a multi-million dollar contract with Candler Health Systems. During the final days of 3Q97, all of the equipment for the Candler Health Systems project was ordered and Daou immediately recognized 20% of the contract price, approximately $1-1.5 million, as revenue, before any contract was signed. By the following quarter, after the Candler Health Systems project revenues had been reported, Daou still did not have a contract and had incurred no actual labor costs. Daou never received the contract and eventually was forced to sell the equipment at a loss.

Plaintiffs further describe how this allegedly premature recognition affected Daou's financial bottom line:

> Had Daou reported revenue in line with the amount it was entitled to bill customers pursuant to its contracts, actually reflecting contract work done to date, revenue for 3Q97 would have been only $5.9 million, 48% less than publicly reported ($11.3 million). CW13, CW17, and CW 27 confirmed that the dramatic growth in Daou's work in progress account, increasing $5.4 million

from 2Q97 to 3Q97, was the result of defendants' premature recognition of revenue.

In addition to pleading the approximate amount by which revenues and earnings were overstated, plaintiffs also provide the dates of some of the related transactions and the identities of the customers and the company employees involved in the transactions. For example, as noted above, plaintiffs described an occurrence with the Centura Health project, which allegedly involved several of the confidential witnesses. CW5 indicated that Daou offered him and two other salaried Field Service employees $100 to come into Daou on the last Saturday of June 1997, unpack and plug in computer equipment ordered for the Centura Health project and immediately record eight hours of labor. CW5 alleged that the purpose of this event "was to justify recognizing 30%-40% of the revenue on the Centura Health project in 2Q97." On another occasion, as noted above, CW5 corroborates other evidence that Daou recognized 20% of the contract price – $1 to 1.5 million – on the Candler Health project before the contract was even signed. Notably, plaintiffs allege that Daou never received the Candler Health contract.

From these allegations, we conclude that plaintiffs have provided enough information for "a court [to] discern whether the alleged GAAP violations were minor or technical in nature, or whether they constituted widespread and significant inflation of revenue." *See In re McKesson*, 126 F. Supp. 2d at 1273. Certainly, prematurely recognizing millions of dollars in revenue is not minor or technical in nature. Further, the complaint, although largely repetitive in its assertions, indicates that these practices allegedly occurred systematically throughout the class period. We hold, therefore, that these allegations

sufficiently state reasons why the reporting statements were misleading and, as an allegation made on information and belief, the facts on which that belief was formed. *See Gompper*, 298 F.3d at 895. These allegations include specific descriptions of how Daou allegedly violated GAAP procedures and, in so doing, misled present and potential investors by artificially inflating Daou's revenues above what should have been reported.

Similarly, we hold that plaintiffs' claims regarding employee training and turnover contain sufficient particularity to support a securities fraud claim. Plaintiffs allege that various defendants made statements indicating that Daou instituted a training program called "Daou University," at which Daou employees were taught technical skills and became certified in computer networking languages and programs. Moreover, plaintiffs contend, in May 1998, D. Daou and McGee represented that Daou had an ongoing program with local universities in San Diego whereby Daou brought in college students to Daou University to train them in systems and networking. According to plaintiffs, neither Daou University, nor the company's program with local college students, existed. Plaintiffs further assert that defendants misled potential investors by understating employee turnover and attrition.

The district court concluded that these allegations lacked sufficient particularity to be actionable. As to employee attrition, for example, the district court noted:

> The one allegation of any substance, Plaintiffs' contention that employee attrition was actually 40%, not 6.8% as represented by Defendants, does not establish misrepresentation on Defendants' part. Defendants' statements that attrition among *technical* employees was at 6.8% was

> made in July 1998, and confidential witnesses' statements that the attrition rate for all employees was at 40% was made in the first quarter of 1998.

However, the complaint itself qualifies the allegation of employee turnover by stating that "[e]mployee turnover, especially among Field Service engineers, exceeded 40%," whereas defendants stated that "attrition within the technical ranks of employees was only 6.8%." Such discrepancy between what Daou executives reported and the allegedly true state of affairs of Daou's employ is adequately misleading to state a claim under 10(b).

We therefore disagree with the district court that Daou's alleged misleading statements of employee turnover and lack of training were not sufficiently particularized to state a cause of action under the PSLRA's heightened pleading standards. Plaintiffs provide several accounts of confidential witnesses claiming that "Daou University" did not in fact exist and that Daou actually had "no in-house training program whatsoever, and according to CW21, the Company was hiring, among others, untrained mechanics and cable pullers as computer technicians, not college graduates." Unlike in *In re Vantive*, where the court held insufficient generic allegations of "inadequate training" or "very high salesforce turnover," *see In re Vantive*, 283 F.3d at 1086-87, the complaint here contains sufficiently detailed allegations of misleading statements or omissions regarding Daou's ability to train and retain its employees to state a claim even under the PSLRA's more rigorous standard.

Plaintiffs' allegations regarding Daou's "pipeline" expectations, however, fail to satisfy the PSLRA's requirements. The complaint alleges that Daou misrepresented

its "pipeline" expectations, stating that its position was "extremely strong" and "remained healthy and would fuel future earnings growth," that "visibility of future earnings was outstanding," and that the company's "momentum was increasing." Although these projections might have been overly optimistic when made, they do not rise to the level of a material misrepresentation actionable after enactment of the PSLRA:

> Congress enacted the PSLRA to put an end to the practice of pleading "fraud by hindsight." *See e.g., Medhekar v. United States Dist. Ct.*, 99 F.3d 325, 328 (9th Cir. 1996) (holding that Congress intended for complaints under the PSLRA to stand or fall based on the actual knowledge of the plaintiffs rather than information produced by the defendants after the action has been filed).

Silicon Graphics, 183 F.3d at 988. Under the PSLRA's "safe harbor" provisions, plaintiffs must prove that "forward-looking" statements were made with "actual knowledge" that they were false or misleading. *Id.* at 993 (Browning, J., concurring in part and dissenting in part) (quoting 15 U.S.C. §§ 78u-5(c)(1)(B), 77z-2(c)(1)(B)) (internal quotation marks omitted). Plaintiffs allege that Daou sales executives would hold weekly or bi-weekly conference calls with McNeill on the status or outlook of prospective projects, and, based on these calls, McNeill and assistants would prepare a Pipeline Report. The complaint further asserts that "[t]he Pipeline Report contained the arbitrary determination of future business based on fixed percentages of proposed contracts' value." The complaint describes the method by which Daou would determine and report its potential sales revenue to analysts and the market:

> The "revenue" listed in the report and provided to analysts and the market was, according to CW9, automatically set at 20% of a contract's total value if a Daou salesperson had even met with the prospective client to discuss a deal, 50% if Daou had submitted a deal proposal, 70% if Daou had submitted a formal bid on the deal, 90% if Daou "appeared to have won" but the deal was not formally closed and 100% when the sale was formerly closed. The pipeline figure, despite defendants' representations, did not actually reflect contracts Daou would actually get, and included millions of dollars on projects that Daou had little or no chance of actually doing.

Plaintiffs provide no specific facts, however, to substantiate the speculative claim that Daou had little or no chance of actually obtaining certain contracts. Further, plaintiffs fail to provide sufficient facts to demonstrate that defendants had actual knowledge that these optimistic statements were false and misleading when made. Therefore, we agree with the district court that these claims are not actionable under section 10(b).

In sum, however, we find that plaintiffs adequately pled fraud as to defendants' alleged misuse of the GAAP protocols and alleged misstatements regarding employee training and turnover to survive a motion to dismiss for failure to state a claim.

2. *Scienter*

Under the PSLRA's new standard, a securities fraud complaint must "state with particularity facts giving rise to a *strong* inference that the defendant acted with the required state of mind." *Gompper*, 298 F.3d at 895 (citing

15 U.S.C. § 78u-4(b)(2) (emphasis added in *Gompper*)); *see also Silicon Graphics*, 183 F.3d at 974 (facts must come closer to demonstrating intent as opposed to mere motive and opportunity). Thus, the complaint must allege that the defendants made false or misleading statements either intentionally or with deliberate recklessness. *See Silicon Graphics*, 183 F.3d at 974. This court considers "whether the total of plaintiffs' allegations, even though individually lacking, are sufficient to create a strong inference that defendants acted with deliberate or conscious recklessness." *Nursing Home*, 380 F.3d at 1230 (quoting *No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. West Holding Corp.*, 320 F.3d 920, 938 (9th Cir. 2003)). In considering whether a strong inference of scienter has been pled, "the court must consider *all* reasonable inferences to be drawn from the allegations, including inferences unfavorable to the plaintiffs." *Gompper*, 298 F.3d at 897 (emphasis in original).

There are several considerations in determining whether the totality of plaintiffs' allegations leads to a strong inference of scienter. General allegations of defendants' "hands-on" management style, their interaction with other officers and employees, their attendance at meetings, and their receipt of unspecified weekly or monthly reports are insufficient. *In re Vantive*, 283 F.3d at 1087. However, specific admissions from top executives that they are involved in every detail of the company and that they monitored portions of the company's database are factors in favor of inferring scienter in light of improper accounting reports. *See Nursing Home*, 380 F.3d at 1234. Moreover, while scienter cannot be established by publishing inaccurate accounting figures, even when in violation of GAAP, *In re Worlds of Wonder Sec. Litig.*, 35

F.3d 1407, 1426 (9th Cir. 1994) ("*WOW*"), significant violations of GAAP standards can provide evidence of scienter so long as they are pled with particularity. *In re McKesson*, 126 F. Supp. 2d at 1273; *see also Nursing Home*, 380 F.3d at 1234 ("It is reasonable to infer that the Oracle executives' detail-oriented management style led them to become aware of the allegedly improper revenue recognition of such significant magnitude[.]").

In addition, "the PSLRA neither prohibits nor endorses the pleading of insider trading as evidence of scienter, but requires that the evidence meet the 'strong inference' standard." *Greebel*, 194 F.3d at 197. "Unusual trading or trading at suspicious times or in suspicious amounts by corporate insiders has long been recognized as probative of scienter." *Id.*; *see also Nursing Home*, 380 F.3d at 1231-32 (considering suspicious insider stock sales as evidence toward meeting the "strong inference" standard). At a minimum, however, "the trading must be in a context where defendants have incentives to withhold material, non-public information, and it must be unusual, well beyond the normal patterns of trading by those defendants." *Greebel*, 194 F.3d at 198.

Plaintiffs allege throughout the complaint that defendants G. Daou, D. Daou, McNeill, and McGee personally directed Daou's recognition of revenue, financial reporting and public statements. They further allege that "[n]ot only were these four defendants the top executives at Daou, but, according to CW23, a former executive assistant to one of the defendants, the Company was run 'top to bottom' by G. Daou and D. Daou, with the assistance of McNeill and McGee." Further, the complaint states that "CW9, a regional Sales Vice President at Daou, confirmed that defendants G. Daou, D. Daou, and McNeill not only

made the decision on how much revenue to recognize without regard to any actual percentage of completion, but directed the practice of automatically recognizing revenue upon contract signing and ordering of equipment."

In one example noted above, the complaint describes Daou executives manually adjusting upward POC amounts in what appears to be in violation of GAAP procedure. CW1 confirmed that such practices occurred, and the complaint indicates that G. Daou, D. Daou, McNeill, and "in particular McGee[ ] presented themselves as knowledgeable about all aspects of the Company's finances, including earnings and revenue recognized under POC accounting." Plaintiffs further allege that "[b]ased on the account of numerous witnesses, all of whom were former members of Daou's executive, Accounting, or Field Services staff, defendants not only knew that the Company's reported financial results and earnings forecast were based on fraudulent accounting, but personally directed the violations of Daou's stated accounting policy and GAAP in order to artificially inflate revenues"; and "CW8 . . . and CW3 . . . both confirmed that it was known throughout Daou at this time [2Q97] that G. Daou, D. Daou, and McNeill were engaged in improper revenue recognition. . . ."

These specific allegations of direct involvement in the production of false accounting statements and reports are even more probative of scienter than the allegations involved in *Nursing Home*, where this court stated that the top executives' admittedly detail-oriented management style led to a reasonable inference that the top executives were aware of significant accounting irregularities. *See Nursing Home*, 380 F.3d at 1234. Indeed, the facts alleged by plaintiffs lead to an even stronger inference: plaintiffs

have alleged with specificity that the top executives actually directed the improper revenue recognition in violation of both GAAP and their own accounting practices.

Plaintiffs also cite suspicious corporate acquisitions and insider stock sales to demonstrate defendants' scienter. They assert that these events demonstrate that defendants "had motive to inflate Daou's stock price and perpetuate the fraudulent scheme and course of business complained of. . . ." The complaint notes that during the class period, Daou acquired 11 companies by exchanging over 6.6 million shares of Daou stock. Plaintiffs present a chart that indicates how many Daou shares "saved" by using artificially inflated stock to purchase the 11 companies. For example, for Daou to purchase INTEGREX Systems Corp. in July 1997, Daou exchanged 700,000 shares of Daou stock valued at $11,400,000; they assert that had Daou's stock been properly valued, they would have been forced to use 1,476,403 additional shares to make the INTEGREX purchase. All told, the chart indicates that Daou saved 19,642,865 shares of its stock in the 11 acquisitions by using its overvalued stock.

The complaint also highlights that defendants G. Daou, D. Daou, McGee, McNeill, and Moragne, sold a total of 1,477,718 shares during the class period for a total of $30,512,393, and in so doing, they knowingly "profit[ed] from the fraud." Although plaintiffs note that defendants took advantage of the artificially inflated stock prices, interestingly, defendants did not sell at the height of Daou's stock prices; e.g., of the stock G. Daou sold during the class period, he received a maximum price of $22.86 per share, whereas Daou's stock price peaked at $34.375 in September 1997. Moragne, on the other hand, sold 11,408

shares at the highest price among defendants who sold stock during the class period, $31.69 per share in November 1997. Despite the fact that defendants did not capitalize on Daou's peak price per share, plaintiffs nonetheless contend that the sales were made at suspicious moments: "the fact that 98% of all insider sales . . . took place on only two trading days (August 15, 1997 and January 29, 1998) is highly suspect and indicative of coordinated selling among defendants." Plaintiffs contend that the sales correspond perfectly with the "huge increase in the price of Daou stock that immediately followed [defendants'] false statements and reports. . . ." Plaintiffs also note that, in addition to the suspicious insider trading by defendants, other Daou executives as well as defendants' family members "dumped" a grand total of 2.5 million shares of Daou stock during the class period at artificially inflated prices. Another chart in the complaint explains the percentage of defendants' sales during the class period compared to their total sales through December 31, 2000. Sales by defendants G. Daou, D. Daou, McNeill and Moragne during the class period represented 100% of their total stock sales as of the end of 2000; only defendant McGee sold stock after the close of the class period.

When considered as a whole, plaintiffs' allegations are sufficient to create a strong inference that all defendants except Moragne acted with at least deliberate recklessness. The complaint relays specific information from actual witnesses, albeit unnamed, that defendants knowingly violated GAAP procedures and present more than mere evidence of a motive and opportunity to commit fraud. Although plaintiffs' allegations of Daou's top-to-bottom management hierarchy, defendants' suspicious stock sales, or the corporate acquisitions *alone* would not

likely demonstrate defendants' scienter, these plus the complaint's specific allegations of deliberate accounting misfeasance create a strong inference of scienter. *See Nursing Home*, 380 F.3d at 1234 ("Considered separately, Plaintiffs' allegations may not create a strong inference of scienter. However, . . . [w]e find that the totality of the allegations does create a strong inference that Oracle acted with scienter[.]"); *cf. Silicon Graphics*, 183 F.3d at 988 (holding insufficient the plaintiff's "generic" allegations). Unlike in *Silicon Graphics*, this complaint contains sufficient "particularity" and "incriminating facts" to distinguish the allegations from the countless "fishing expeditions" which the PSLRA was designed to deter. *See Silicon Graphics*, 183 F.3d at 988 (citing H.R. Conf. Rep. No. 104-369, at 37).

However, we affirm the district court's dismissal of defendant Moragne as relates to the section 10(b) and Rule 10b-5 claims. The complaint's main allegations to establish scienter against defendant Moragne are suspicious stock sales, and those allegations, as pled in plaintiffs' complaint, do not rise to the level of a strong inference. Importantly, there is nothing to suggest Moragne was involved in the day-to-day operations of Daou, much less heavily involved in the details and personally directing the accounting irregularities. Our affirmance as to Moragne, however, does not imply that suspicious stock sales, by themselves, can never lead to a strong inference. The facts alleged in this complaint simply do not support a strong inference of scienter.

3. *Causation*

A court must also consider whether the plaintiff has shown some causal connection between the fraud and the securities transaction in question. *The Ambassador Hotel*, 189 F.3d at 1026; *Levine v. Diamanthuset, Inc.*, 950 F.2d 1478, 1486 (9th Cir. 1991) ("[The] plaintiff must establish a connection between the defendant's alleged misrepresentation and the security at issue."). "Deception related to the value or merit of the securities in question has sufficient connection to securities transactions to bring the fraud within the scope of § 10(b)." *The Ambassador Hotel*, 189 F.3d at 1026 (citation omitted).

The causation requirement can be broken down into two necessary elements: actual cause ("transaction causation") and proximate cause ("loss causation"):

> [I]n an action brought under Rule 10b-5 for material omissions or misstatements, the plaintiff must prove both transaction causation, that the violations in question caused the plaintiff to engage in the transaction, and loss causation, that the misrepresentations or omissions caused the harm.

Id. at 1027 (quoting *Hatrock v. Edward D. Jones & Co.*, 750 F.2d 767, 773 (9th Cir. 1984)). Thus, to prove transaction causation, the plaintiff must show that, but for the fraud, the plaintiff would not have engaged in the transaction at issue; to prove loss causation, the plaintiff must demonstrate a causal connection between the deceptive acts that form the basis for the claim of securities fraud and the injury suffered by the plaintiff. *Id.*

Here, we conclude that plaintiffs have sufficiently demonstrated defendants' fraud, such that the "[d]eception

related to the value or merit of the securities in question" creates a sufficient connection to the securities transactions to bring the fraud within the scope of section 10(b). *See id.* at 1026 (citation omitted). Such fraud in disclosing Daou's financial position would likely suffice to prove transaction causation: but for the fraud, plaintiffs would not have engaged in the transaction at issue. *See id.* at 1027.

As the district court pointed out, however, establishing "loss causation" is a more difficult task, as the district court found that Daou's improper use of the POC method was not linked to the decline in Daou's share price. The court stated:

> It is undisputed that Daou's 3Q98 financial results were dismal, and that this led to the precipitous drop in the Company's stock value. However, in the TAC, Plaintiffs have not adequately been able to link the decline in share price to any purported improper revenue recognition by Defendants. Plaintiffs point to the fact that market analysts questioned whether Defendants had been "cooking" Daou's books after the 3Q98 results were revealed, but this is merely speculation. Notably, the TAC does not allege that there were any negative public statements, announcements or disclosures at the time the stock price dropped that Defendants were engaged in improper accounting practices.

In other words, if the improper accounting did not lead to the decrease in Daou's stock price, plaintiffs' reliance on the improper accounting in acquiring the stock would not be sufficiently linked to their damages.

An independent assessment of the TAC, however, indicates that the price of the stock fell precipitously after defendants revealed figures vastly different than those reported in a press conference two weeks prior. The complaint also anonymously quotes an analyst who allegedly stated, "[w]hen you say one thing on the conference call and report something different on the 10-Q, that raises concern. . . . *You have got to question whether they are manufacturing earnings.*" Although some of the allegations do call for speculation, the foregoing, if assumed true, is sufficient to show that the drop in Daou's stock price was the direct result of their financial misstatements and, in turn, caused plaintiffs' damages.

4. *Reliance and Damages*

Plaintiffs attest that they relied on defendants' material misrepresentations in choosing to invest in Daou during the class period and were damaged thereby. Justifiable reliance "is a limitation on a rule 10b-5 action which insures that there is a causal connection between the misrepresentation and the plaintiff's harm." *Paracor*, 96 F.3d at 1159 (citation and internal quotation marks omitted). If Daou indeed based its public disclosures of its financial viability on fraudulent accounting, then, in turn, plaintiffs justifiably relied on such disclosures in making the decision to invest. Moreover, if plaintiffs indeed justifiably relied on Daou's public misrepresentations and, in turn, bought Daou stock at inflated prices, they incurred damages from Daou's fraud. Such assertions are sufficient to survive a motion to dismiss under Federal Rule of Civil Procedure 12(b)(6).

b. *Plaintiffs' 1933 Securities Act section 11 claim*

Unlike section 10(b), section 11 of the 1933 Securities Act creates a private remedy for any purchaser of a security if "any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading." 15 U.S.C. § 77k(a). "The plaintiff in a § 11 claim must demonstrate (1) that the registration statement contained an omission or misrepresentation, and (2) that the omission or misrepresentation was material, that is, it would have misled a reasonable investor about the nature of his or her investment." *In re Stac Electronics Sec. Litig.*, 89 F.3d 1399, 1403-04 (9th Cir. 1996) ("*In re Stac*") (citation and internal quotation marks omitted). "No scienter is required for liability under § 11; defendants will be liable for innocent or negligent material misstatements or omissions." *Id.* (citing *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983)).

Although section 11 does not contain an element of fraud, a plaintiff may nonetheless be subject to Rule 9(b)'s particularity mandate if his complaint "sounds in fraud":

> [T]he plaintiff may allege a unified course of fraudulent conduct and rely entirely on that course of conduct as the basis of a claim. In that event, the claim is said to be "grounded in fraud" or to "sound in fraud," and the pleading of that claim as a whole must satisfy the particularity requirement of Rule 9(b).

Vess, 317 F.3d at 1103-04; *see also In re Stac*, 89 F.3d at 1404-05 ("We now clarify that the particularity requirements of Rule 9(b) apply to claims brought under Section

11 [of the 1933 Securities Act] when, as here, they are grounded in fraud.").

In a case where fraud is not an essential element of a claim, only allegations of fraudulent conduct must satisfy the heightened pleading requirements of Rule 9(b). *Vess*, 317 F.3d at 1105. "Allegations of non-fraudulent conduct need satisfy only the ordinary notice pleading standards of Rule 8(a)." *Id.* As the Fifth Circuit wrote:

> Where averments of fraud are made in a claim in which fraud is not an element, an inadequate averment of fraud does not mean that no claim has been stated. The proper route is to *disregard* averments of fraud not meeting Rule 9(b)'s standard and then ask whether a claim has been stated.

Id. (citing *Lone Star Ladies Inv. Club v. Schlotzsky's Inc.*, 238 F.3d 363, 368 (5th Cir.2001) ("*Lone Star*")) (emphasis added in *Vess*). As the Eighth Circuit elaborated:

> The only consequence of a holding that Rule 9(b) is violated with respect to a § 11 claim would be that any allegations of fraud would be *stripped from the claim.* The allegations of innocent or negligent misrepresentation, which are at the heart of a § 11 claim, would survive.

Id. (citing *Carlon v. Thaman* (*In re NationsMart Corp. Sec. Litig.*), 130 F.3d 309, 315 (8th Cir. 1997)) (emphasis added in *Vess*). "Thus, if particular averments of fraud are insufficiently pled under Rule 9(b), a district court should 'disregard' those averments or 'strip' them from the claim. The court should then examine the allegations that remain to determine whether they state a claim." *Id.*

A district court need not rewrite a deficient complaint however. *Lone Star*, 238 F.3d at 368. Rule 9(b) may prove fatal to 1933 Securities Act claims "grounded in fraud" when the complaint makes a "wholesale adoption" of the securities fraud allegations for purposes of the Securities Act claims. *Id.* (citations, internal quotation marks, and emphasis omitted). In such cases,

> a district court is not required to sift through allegations of fraud in search of some "lesser included" claim of strict liability. It may dismiss. If it does so, it should ordinarily accept a proffered amendment that either pleads with the requisite particularity or drops the defective allegations and still states a claim.

Id. at 368-69.

Here, plaintiffs' TAC "sounds in fraud." Notably, the first sentence of the complaint introduces the action as one "brought on behalf of a class of purchasers of Daou Systems, Inc. . . . common stock [during the class period], seeking damages *resulting from a fraudulent scheme and course of business by defendants*, which harmed [such] purchasers." (emphasis added). Thereafter, the complaint goes on to allege myriad misrepresentations made by defendants, of which defendants had full knowledge, which induced plaintiffs' reliance, and which caused plaintiffs damages. The complaint fully incorporates all allegations previously averred in the complaint for purposes of all their claims. Because the complaint makes a "wholesale adoption" of the securities fraud allegations for purposes of the Securities Act claims, this court need not "sift through allegations of fraud in search of some 'lesser included' claim of strict liability"; indeed, plaintiffs here never rely on such conduct as negligence or mistake in

stating their claims. *Cf. Vess*, 317 F.3d at 1105-06. Thus, all of plaintiffs' claims, whether including an element of fraud or not, must satisfy the heightened pleading standard set out in Rule 9(b). *See In re Stac*, 89 F.3d at 1404-05.

To survive dismissal, therefore, plaintiffs must demonstrate, with particularity, "(1) that the registration statement contained an omission or misrepresentation, and (2) that the omission or misrepresentation was material, that is, it would have misled a reasonable investor about the nature of his or her investment." *In re Stac*, 89 F.3d at 1403-04 (citation and internal quotation marks omitted). Here, as discussed above, plaintiffs have shown with sufficient particularity that defendants engaged in materially false revenue reporting in the various statements disclosed during the class period. Thus, plaintiffs' section 11 claims against all defendants, including defendant Moragne, survive dismissal under Rule 12(b)(6).

c. *Plaintiffs' claims under section 12(a)(2)*

Section 12(a)(2) of the 1933 Securities Act imposes civil liability on any person for use of any instrumentality of interstate commerce to offer or sell securities by means of a prospectus or oral communication that includes "an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading. . . ." 15 U.S.C. § 77*l*(a)(2). To establish liability under section 12(a)(2), a plaintiff must allege that the defendants did more than simply urge another to purchase a security; rather, the plaintiff must show that

the defendants solicited purchase of the securities for their own financial gain:

> The person who gratuitously urges another to make a particular investment decision is not, in any meaningful sense, requesting value in exchange for his suggestion or seeking the value the titleholder will obtain in exchange for the ultimate sale. The language and purpose of § 12(1) suggest that liability extends only to the person who successfully solicits the purchase, *motivated at least in part by a desire to serve his own financial interests or those of the securities owner.* If he had such a motivation, it is fair to say that the buyer "purchased" the security from him. . . .

Pinter v. Dahl, 486 U.S. 622, 647 (1988) (emphasis added).

The purchaser must also demonstrate damages to recover under section 12. Because section 12 provides that a person who sells a security through use of material misstatements or omissions "shall be liable . . . to the person purchasing such security from him . . . [for] the consideration paid for such security with interest thereon, less the amount of any income received thereon, . . . or for damages if he no longer owns the security," 15 U.S.C. § 77*l*(a), there can be no recovery unless the purchaser has suffered a loss. *In re Broderbund/Learning Co. Sec. Litig.*, 294 F.3d 1201, 1205 (9th Cir. 2002). "That is to say, what the purchaser is entitled to is 'a return of the consideration paid, reduced by the amount realized when he sold the security and by any "income received" on the security.'" *Id.* (citing *Randall v. Loftsgaarden*, 478 U.S. 647, 656 (1986) (citation omitted)). Causation, however, is not a necessary element of a prima facie case under section 12 of the Securities Act. *See Casella v. Webb*, 883 F.2d 805, 808

& n.8 (9th Cir. 1989) (holding that if the alleged misrepresentations are material, a plaintiff is entitled to recovery whether or not the misrepresentations caused the alleged damage).

The district court failed to reach the issue of whether Daou and the individual defendants were "directly involved" in the actual solicitation of a securities purchase because it had determined that "Plaintiffs' 12(a)(2) claim necessarily fails for lack of adequate allegations that Defendants made any false or misleading statements or omissions of material fact." Because we hold that plaintiffs adequately averred material misrepresentations on the part of defendants' statements in their various periodic disclosures, the district court must revisit the remaining elements of plaintiffs' section 12(a)(1) claim to determine whether they are sufficient to survive dismissal under Rule 12(b)(6).

d. *Plaintiffs' claims under sections 15(a) of the 1933 Securities Act and 20(a) of the 1934 Exchange Act*

Section 15(a) of the 1933 Securities Act imposes joint and several liability upon every person who controls any person liable under sections 11 or 12. 15 U.S.C. § 77*o*. Such section provides:

> Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k or 77*l* of this title, shall also be liable jointly and severally with and to the same extent as such controlled

> person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

Id. To state a claim under this section, a plaintiff must allege that the individual defendants had power or influence over the company and that the individual defendants were culpable participants in the company's alleged illegal activity. *Durham v. Kelly*, 810 F.2d 1500, 1504 (9th Cir. 1987).

Similarly, section 20(a) of the 1934 Exchange Act provides that "[e]very person who, directly or indirectly, controls any person liable under any provision of [chapter 2B] or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person. . . ." 15 U.S.C. § 78t. "Controlling person" under both of the above acts is given the same interpretation because "section 20(a) [of the Exchange Act] is an analogue of section 15 of the Securities Act." *Durham*, 810 F.2d at 1503 (citation omitted) (alteration in original).

Because the district court did not find that Daou or the individual defendants had engaged in anything but "an exercise of Defendants' business judgment," it also rejected plaintiffs' contention that defendants should be liable under sections 15(a) or 20(a). Again, because we conclude that plaintiffs have adequately set forth a claim of accounting fraud, the district court must reassess the viability of plaintiffs' sections 15 and 20 claims as well.

CONCLUSION

Plaintiffs' complaint, although lengthy and often repetitive, states a sufficiently particularized claim for accounting fraud under the heightened pleading standards of the PSLRA. Accordingly, we need not reach plaintiffs' request for leave to amend nor defendants' request for attorney's fees. The case is remanded to the district court for further proceedings consistent with this opinion.

AFFIRMED in part; REVERSED in part and REMANDED.

APPENDIX C

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF CALIFORNIA

In re DAOU SYSTEMS, INC., SECURITIES LITIGATION,	Civil No. 98-CV-1537-L(CGA)
This Order Relates to: ALL ACTIONS	**ORDER GRANTING WITHOUT PREJUDICE DEFENDANTS' MOTION TO DISMISS CONSOLIDATED SECOND AMENDED CLASS ACTION COMPLAINT [doc. #91]**
	(Filed Mar. 27, 2002)

Defendants' move to dismiss plaintiffs' consolidated second amended class action ("SAC") complaint. Plaintiffs oppose dismissal. Having fully reviewed the matters presented, including the oral argument of the parties, the Court enters the following decision for the reasons set forth below.

MOTION TO DISMISS

A. Applicable Law Regarding Motions to Dismiss Securities Class Actions

When ruling on a motion to dismiss, the Court accepts all material allegations of fact as true and must construe those allegations in the light most favorable to the non-moving party. *See Durning v. First Boston Corp.*, 815 F.2d 1265, 1267 (9th Cir. 1987); *North Star Int'l v. Arizona Corp. Comm'n*, 720 F.2d 578, 581 (9th Cir. 1983). If the complaint fails to state a claim, the Court should grant leave to amend unless it appears beyond a doubt the

plaintiff would not be entitled to relief under any set of facts proved. *Halet v. Wend Inv. Co.*, 672 F.2d 1305, 1309 (9th Cir. 1982).

Securities Exchange Commission ("SEC") Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails . . .
>
> (a) to employ any device, scheme or artifice to defraud,
>
> (b) to make any untrue statement of a material fact or omit to state a material act necessary in order to make the statements made in the light of the circumstances under which they were made, not misleading, or
>
> (c) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

In order for plaintiffs to properly allege their first claim of relief brought under section 10(b) of the Securities Exchange Act and Rule 10b-5, they must state the following: (1) defendants made a false statement or omission with regard to a material fact; (2) in connection with the purchase or the sale of a security; (3) with scienter; (4) upon which plaintiffs reasonably relied; (5) to his/her harm or detriment. *See McCormick v. Fund Am. Companies, Inc.*, 26 F.3d 869 (9th Cir. 1994). Scienter is a "mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193-94 n. 12 (1976).

In December of 1995, Congress enacted the Private Securities Litigation Reform Act of 1995 ("PSLRA"), which amended the 1934 Act. Complaints alleging securities fraud must meet the heightened pleading standards of both Federal Rule of Civil Procedure 9(b) and the PSLRA. Rule 9(b) requires "in all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally." The PSLRA specifies the required pleading standard for securities fraud actions:

> (1) Misleading statements and omissions
>
> In any private action arising under this chapter in which the plaintiff alleges that the defendant –
>
> (A) made an untrue statement of a material fact; or
>
> (B) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading; the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.
>
> (2) Required state of mind
>
> In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind the complaint shall, with respect to each act or omission alleged to

> violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

15 U.S.C. §78u-4(b)(1), (2) (1997). This language essentially codified the existing requirements embodied in Rule 9(b) of the Federal Rules of Civil Procedure. *See, e.g, Greebel v. FTP Software, Inc.*, 194 F.3d 185, 193 (1st Cir. 1999).

Under Ninth Circuit case law, Rule 9(b) imposes two distinct requirements on complaints alleging securities fraud. First, the basic notice requirements of Rule 9(b) require the complaint to "state precisely the time, place, and nature of the misleading statements, misrepresentations, or specific acts of fraud." *Kaplan v. Rose*, 49 F.3d 1363, 1370 (9th Cir. 1994); *Walling v. Beverly Enters.*, 476 F.2d 393, 397 (9th Cir. 1973). The Rule imposes a second requirement that the complaint "set forth an explanation as to why the statement or omission complained of was false and misleading." *In re GlenFed Sec. Litig.*, 42 F.2d 1451, 1548 (9th Cir. 1994) (en banc). A complaint may satisfy this second requirement in many ways. It may demonstrate that the false or misleading character of a statement was clear from facts that existed all along and were later revealed. *Id.* at 1549. It may also "point[] to inconsistent contemporaneous statements or information . . . which were made by or available to the defendants." *Id.* A complaint may not, however, demonstrate that a statement was false or misleading when made "merely by pointing to later inconsistent statements or conditions." *Id.*

Finally, the PSLRA requires complaints alleging federal securities fraud to "state with particularity facts giving rise to a strong inference that the defendant acted

with the required state of mind." 15 U.S.C. § 78u-4(b)(2). As recently interpreted by the Ninth Circuit, this language requires "a private securities plaintiff . . . [to] plead, in great detail, facts that constitute strong circumstantial evidence of deliberately reckless or conscious misconduct." *In re Silicon Graphics Sec. Litig.*, 183 F.3d 970, 974 (9th Cir. 1999).

The PSLRA provides that "the court shall, on the motion of any defendant, dismiss the complaint if the requirements of paragraphs (1) and (2) are not met." 15 U.S.C. § 78u-4(b)(3)(A).

B. Procedural Background

Plaintiffs initially filed a Complaint on August 24, 1998. On December 21, 1998, the parties stipulated to the filing of a consolidated amended complaint ("CAC"). On April 13, 1999, defendants filed a motion to dismiss the CAC. The case was stayed, however, pending the ruling in the *In re Silicon Graphics Sec. Litig.* case by the Ninth Circuit Court of Appeals. 183 F.3d 970 (9th Cir. 1999). After the *Silicon Graphics* decision was announced, plaintiffs filed a second amended class action complaint ("SAC") on January 24, 2000 [doc. #65] which is the subject of the current motion to dismiss.

C. Factual Background

DAOU Systems, Inc. ("Daou") provides information management services for hospitals and other health care organizations, i.e., defendant designs a computer network, implements the design by purchasing, installing and testing the necessary equipment, and training the client's

employees. After existing for ten years, Daou held an initial public offering of its stock on February 13, 1997. The value of Daou increased from $9 to $20 per share. A secondary offering of stock was held on August 15, 1997.

Daou contends that the nature of its business, i.e., long-term contracts that are completed in stages, require it to use a method of accounting called Percentage Of Completion ("POC"), which is a Generally Accepted Accounting Practice ("GAAP"). Under the POC method, Daou recognized revenue based upon how much labor had been done on a contract as a percentage of the total labor Daou estimated would be needed to complete the project. During the class period. February 13, 1997, the time of the initial IPO, through October 28, 1998, Daou's stock prices ranged from a high on September 23, 1997 of $34.37 to a low on October 29, 1998 of $3.25.

The essence of the SAC is that defendants engaged in accounting fraud by using the Percentage of Completion ("POC") accounting method in a manner that violated GAAP and defendants made statements to analysts that were materially false when made.

D. Accounting Fraud

Plaintiffs contend that defendants misrepresented the Company's financial condition by using, various undisclosed practices that violated GAAP, specifically by using the Percentage of Completion Accounting Method ("POC") even though the POC method is a valid, well recognized generally acceptable accounting practice. A POC accounting provides for comparing labor costs incurred to date with total estimated labor costs. Under a POC accounting,

revenue is recognized only in line with reasonable estimates of the percentage of a contract completed. Plaintiffs contend that defendants fraudulently recognized revenue before it was earned; hid operating expenses in non-recurring merger charges; and booked one-time, extraordinary revenues without telling anyone. Notwithstanding that the POC accounting method does not specify what percentage is appropriate to book, plaintiffs further assert that Daou would book revenue in an arbitrary percentage amount. In particular, plaintiffs contend that in violation of GAAP, defendants "oftentimes . . . would book 20% of a contract's value as revenue based on nothing more than placing an order for equipment to service that project, without regard to labor costs or the percentage of a project actually completed . . . [or] [r]egardless of labor costs remaining to be completed, defendants would recognize 50-60% of a contract as soon as equipment was forwarded from Daou's warehouse to a customer." (Opp. at 11, citing SAC ¶15, 16, 38, 39). Plaintiffs further state that because defendants violated POC by recognizing revenue before it was earned, Daou's unbilled receivables increased dramatically because Daou was unable to bill its customers for work it had not performed.

Plaintiffs also point to August 13, 1998, when Daou filed its Form 10-Q with the SEC, wherein Daou allocated ordinary and one-time expenses differently than it had reported two weeks earlier in a Company press release and in a conference call with analysts. Initially, Daou reported earnings of $0.12, excluding $2.9 million of non-recurring merger charges and general and administrative (G&A) expenses of $2.34 million. But in its 10-Q, Daou reported merger and acquisition expenses of only $1.0 million and G&A of $3.54 million.

"Properly pled, overstating of revenues may state a claim for securities fraud, as under GAAP, 'revenue must be earned before it can be recognized.'" *Hockey v. Medhekar,* 30 F. Supp. 2d 1209, 1216 (N.D. Cal. 1998) (*quoting Provenz v. Miller,* 102 F.3d 1478, 1484 (9th Cir. 1996)). "'To properly state a claim for accounting fraud, plaintiffs must 'plead facts sufficient to support a conclusion that [d]efendant [] prepared the fraudulent financial Statements and that the alleged financial fraud was material.'" *Id.* (*quoting In re Oak Tech. Sec. Litig.,* 1997 WL 448168, * 8 (N.D. Cal. 1997)) (alterations in original). Violations of GAAP standards can provide evidence of scienter. *Greebel v. FTP Software, Inc.,* 194 F.3d 185, 203 (1st Cir. 1999); *see In re McKesson,* 126 F. Supp. 2d at 273 ("However, when significant GAAP violations are described with particularity in the complaint, they may provide powerful indirect evidence of scienter. After all, books do not cook themselves.") "To support even a reasonable inference of scienter, however, the complaint must describe the violations with sufficient particularity: 'a general allegation that the practices at issue resulted in a false report of company earnings is not a sufficiently particular claim of misrepresentation.'" *Greebel,* 194 F.3d at 203 (*quoting Gross v. Summa Four, Inc.,* 93 F.3d 987, 996 (1st Cir. 1996)). When pleading irregularities in revenue recognition, plaintiffs should allege "basic details as the approximate amount by which revenues and earnings were overstated," "the products involved in the contingent transaction," "the dates of any of the transactions," or the identities of any of the customers or [company] employees involved in the transactions." *Id.* at 204; *accord In re McKesson,* 126 F. Supp. 2d at 1273. Plaintiffs need not allege *each* of those particular details, *see Greebel,* 194 F.3d at 204, but they must allege enough information so that "a court can

discern whether the alleged GAAP violations were minor or technical in nature, or whether they constituted widespread and significant inflation of revenue." *In re McKesson*, 126 F. Supp. 2d at 1273.

Plaintiffs list a variety of allegedly undisclosed practices they contend constituted improper revenue recognition, and later allege these actions violate the GAAP provisions that require that revenue not be recognized until a reasonable estimate of the percentage of a contract is completed. But plaintiffs fail to give sufficient details of when these improper accounting practices occurred. Simply stating the overstatement of revenues was a "common practice" is not enough. Similarly, plaintiffs to do not state how the practices actually violated the POC method under GAAP. The POC accounting method is not a rigid method of accounting. Rather, the estimates of a project's completion must be reasonable under GAAP. Plaintiffs do not provide adequate facts to show an unreasonable variance between what the defendants recognized as revenue and what they should have recognized under proper application of the POC accounting method. Plaintiffs have not alleged facts demonstrating that defendants' use of the POC method was unreasonable or that plaintiff's allegations are anything more than a challenge to Daou's corporate judgment.

E. False Statements

Plaintiffs also contend that defendants made a series of false and misleading representations. As previously noted, defendants challenge the adequacy of the SAC's allegations of false statements under the PSLRA and Rule

9(b) standards. The false statements plaintiffs allege defendants made are found in various portions of the SAC.

> 65. On February 13, 1997, defendants offered and sold in an IPO 2,000,000 shares of Daou's common stock to the public at $9 per share. In the Registration Statement and Prospectus issued in connection with the IPO and signed by defendants G. Daou, D. Daou, McGee and Moragne, defendants represented that Daou typically provided its services on a fixed fee basis and that the Company recognized revenue using the POC accounting method:
>
> Contract revenue for the development and implementation of network solutions is recognized on the percentage-of-completion method with progress to completion measured by labor costs incurred to date compared to total estimated labor costs. Provisions for estimated losses on contracts, if any, are made during the period when the loss becomes probable and can be reasonably estimated. Revenues recognized in excess of amounts billed and project costs are classified as contract work in progress.
>
> 66. Defendants further represented in the Prospectus that "[c]ertain contract payment terms may result in customer billing occurring at a pace slower than revenue recognition. The resulting revenue recognized in excess of amounts billed and project costs are classified as contract work in progress on the Company's balance sheet." For Q4 1996, Daou reported In the Prospectus revenues of $6,954,000, operating earnings of $126,000, accounts receivable of $4,085,000 and contract work in progress of $3,600,000.
>
> 67. Defendant's statements in the Prospectus were false and misleading because, as described herein, defendants improperly recognition of Daou's revenue

utilizing the POC in violation of GAAP, including falsifying Q4 1996.

68. On April 21, 1997, the Company issued a press release announcing its financial results for first quarter ended March 31, 1997, reporting revenues of $5,204,000, operating losses of $500,000, accounts receivable of $3,372,000 and contract work in progress of $4,850,000:

> First-quarter revenues for the period ending March 31, 1997, were $5.2 million, an increase of 123 percent over the $2.3 million reported for the first quarter of 1996. The company reported a net loss of $232,000, or 2 cents per share. That compares with a net loss of $163,000, or 2 cents per share, for the same period in 1996.
>
> The increase in revenues was primarily attributable to the introduction of the company's information systems outsourcing services, which the company did not provide in the first quarter of 1996, as well as an increase in network implementation revenues.
>
> The increased loss in net income was impacted by increased expenses associated with the regionalization of the company's sales organization, the addition of sales personnel, and the expansion of marketing programs. The company reported total sales and marketing expenses of $1.02 million for the first quarter of 1997, an Increase of 209 percent over the $330,000 for the first quarter of 1996.

The Release quoted defendant G. Daou as stating:

"We are pleased with the progress we've made in implementing our 1997 corporate growth strategy," said

Georges Daou, chief executive officer of DAOU Systems.

69. Subsequent to the release of its Q1 1997 results, Daou held a conference call for analysts, money and portfolio managers, institutional investors and large shareholders to discuss Daou's Q1 results, its business and its prospects. During the call, and in follow-up conversations with analysts, G. Daou, D. Daou, McGee and McNeill stated:

- Daou's strong Q1 results were due to the success of the Company's growth strategy which had positioned the Company for strong growth going forward.

- Daou had recently hired several new sales executives and was expanding its regional sales offices throughout the country which would help Daou achieve its objective of capturing a larger share of the healthcare information technology market.

- Daou had hired and was increasing the number of network and design engineers.

- Daou had an extremely strong backlog of $63 million and pipeline of orders, which would lead to continued strong revenue and earnings growth in 1997 and 1998.

- Daou saw significant increases in new business on all fronts and repeat business from existing clients with excellent visibility going forward.

- With its reorganization well underway, Daou was on track to achieve 1998 EPS of $0.42-$0.47.

70. On or about April 23, 1997, Daou filed its report on Form 10-Q for the quarter ended March 31, 1997, signed by defendants D. Daou and McGee. This report

> contained the same false financial information as was contained in the April 21, 1997 press release. Defendants represented that "[t]hese financial statements reflect all adjustments, consisting of only normal recurring adjustments which in the opinion of management, are necessary to fairly present the financial position [of Daou] at March 31, 1997 and 1996."

Allegations of material false statements or omission must specify: (1) each statement alleged to have been misleading; (2) the *reason* or reasons why the statement is misleading; and (3) if an allegation is made on information and belief, the complaint must state with particularity all facts on which that belief is based, 15 U.S.C. § 78u-4(b)(1). In addition, if scienter is an element of the claim, the complaint must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). Finally, if the alleged material statement or omission is a "forward-looking statement," the required level of scienter is actual knowledge. 15 U.S.C. § 78u-5(c).

Here, it is clear that plaintiffs fail to specify each particular statement alleged to have been misleading, the reasons why the statement is misleading and the particular facts on which plaintiffs base their belief. Many statements are merely predictions of the future or state generalized corporate optimism – neither of which is actionable. Plaintiffs' purported "facts" are largely unsupported conclusions. Moreover, plaintiffs have not alleged facts that show why potentially actionable statements were false at the time they were made. The type of allegations plaintiffs make are conclusory and vague. Plaintiffs do not set forth the who, what, where, when and how of various communications that they allege are actionable as

fraudulent and therefore, do not meet the heightened pleading requirements of the PSLRA for fraud by using vague language of generalities.

F. Actual Knowledge

Plaintiffs contends that defendants had actual knowledge of the information that is allegedly fraudulent because they had the opportunity and motive to commit the alleged fraud. (SAC, ¶49). Plaintiffs further assert that defendants had access to the "adverse non-public information about Daou's business, finances and future prospects," and thus actual knowledge through e-mails sent "to defendants through McNeill by the seven regional VP's [sic] each month, . . . [through] weekly or biweekly sales conference calls, . . . quarterly meetings] of Daou's vice presidents and corporate officers in San Diego, . . . and regularly held meetings involving G. Daou, D. Daou, McNeill, McGee and Ringwall." (SAC, ¶¶51, 52).

Published decisions in the Ninth Circuit hold that a complaint does not adequately plead scienter by claiming that key officers knew the true facts by virtue of their "hands-on" positions and involvement in the day-to-day management of the company. *In re Splash*, 160 F. Supp. 2d 1059, 1080-81 (N.D. Cal. 2000); *In re Autodesk, Inc. Sec. Litig.*, 132 F. Supp. 2d 833, 843-44 (N.D. Cal. 2000); *see In re Read-Rite Corp. Sec. Litig.*, 115 F. Supp. 2d 1181, 1185 (N.D. Cal. 2000) (holding that "one could reasonably infer that persons with [the defendants'] respective job titles would be aware of major developments concerning a key customer's refusal to implement a major product line. However, under current law, the mere 'existence of a

reasonable inference does not satisfy the Reform Act's requirement of a strong implication.")

For example, in *In re Splash*, the SAC alleged that the individual defendants were "hands on" managers in "constant contact" with its two sole customers and that they knew of the true facts because of unspecified internal corporate documents, unspecified conversations with unspecified corporate officers and employees, attendance at unspecified management and/or Board meetings, unspecified order intake and backlog reports, and unspecified disclosures and data from the company's customers. *In re Splash*, 160 F. Supp. 2d at 1079. The court found these allegations insufficient because the complaint: (1) did not identify the internal corporate documents by identifying their contents, who prepared them, which officers reviewed them, and from whom plaintiffs obtained the information; (2) did not identify any specific conversations between specific officers and employees; (3) did not identify any specific management or Board meeting at which adverse non-public information was disclosed or discussed; (4) did not identify any specific "order intake reports," "backlog reports," or "shipment reports" that reflected the information; and (5) did not identify any specific information the company's top executives received from the customers, or the circumstances surrounding the receipt. *Id.* at 1080. The court also found the plaintiffs' identification of one of the defendants as having had contact with the company's customers deficient because the complaint did not identify a specific communication between the executive and the customers, the date on which any of those communications occurred, how plaintiffs learned of the communications, the form in which the contact or communication was had, or specifies concerning

the information provided or received during the contact. *Id.*

Similarly, in *In re Autodesk*, the plaintiffs alleged scienter based on the defendants' top executive positions in the company, involvement in the day-to-day management of the company's business, and because of weekly internal reports, such as sales reports, order reports, backlog reports, "revenue cycles and trends" reports, "allowance and general reserve" reports, and "monthly and pending danger" reports. *In re Autodesk*, 132 F. Supp. 2d at 843-44. The court agreed with the defendants, holding that "plaintiffs must do more than allege that these key officers had the requisite knowledge by virtue of their 'hands on' positions, because that would eliminate the necessity for specially pleading scienter, as any corporate officer could be said to possess the requisite knowledge by virtue of his or her position." *Id.* at 844; *accord In re Splash*, 160 F. Supp. 2d at 1081 n.17.

Applying this authority, the SAC's scienter allegations based on "actual knowledge" by defendants are deficient. The SAC contends defendants knew about the Company's improper revenue recognition by virtue of their positions in the Company. But there are no allegations identifying specific conversations. Board meetings, or reports where these individuals purportedly learned of the true and adverse information. Rather, as in *In re Autodesk* and *In re Splash*, the SAC's allegations are conclusory.

Thus, plaintiffs do not provide the type of specific allegations to support their contentions that defendants had actual knowledge that their statements were false when made as is required by *Silicon Graphics*. Plaintiffs must provide specific facts indicating that each defendant

actually knew that his statements were false at the time when made. Plaintiffs' conclusion that because the defendants had access to internal corporate documents and information, had conversations with other corporate officers and employees, and had attended various meetings, the statements were false when made. Moreover, plaintiffs do not allege how much revenue should have been recognized under the POC method and do not calculate the specific amount of revenue that defendants allegedly improperly recognized; therefore, it is impossible to infer from the SAC that any revenue was improperly recognized. Plaintiffs have the burden to allege what amount of revenue should have been reported as compared with what was reported. The complaint must allege a variance between what the defendants recognized and what they should have recognized under proper application of the POC accounting method.

Plaintiff also rely on alleged insider trading to demonstrate scienter. Defendants are alleged to have sold $30 million in Daou stock in a six month period; family members sold $18 million; and other key Daou insiders sold $6 million. Plaintiff asserts these sales were suspicious both as to time and amount because no defendant ever sold Daou shares except those sold during the Class Period (SAC, ¶ 59) and the sales of Daou stock that occurred between August 1997 and January 1998 where [sic] when stock prices were at all-time highs.. However, plaintiffs attempt to combine all defendants' sales together. Moreover, Daou's stock price hit an all-time high in September 1998, nine months after the alleged insider sales.

Plaintiffs have not alleged sufficiently that the sales were "dramatically out of line with prior trading practices"

as to each individual defendant. *Silicon Graphics,* 183 F.3d at 987.

G. Loss Causation

One of the elements of a Rule 10b-5 cause of action that a Plaintiff must plead and prove is loss causation. 17 C.F.R. § 240.10b-5; *Binder,* 184 F.3d at 1063. "The causation requirement in Rule 10b-5 securities fraud cases includes 'both transaction causation, that the violations in question caused the plaintiff to engage in the transaction, and loss causation, that the misrepresentations or omissions caused the harm.'" *Binder,* 184 F.3d at 1065 (*quoting McGonigle v. Combs*, 968 F.2d 810, 820 (9th Cir. 1992)). In the Ninth Circuit, loss causation is satisfied where "the plaintiff shows that 'the misrepresentation touches upon the reasons for the investment's decline in value.'" *Id.* at 1066 (*quoting McGonigle,* 968 F.2d 821); *accord Provenz v. Miller*, 102 F.3d 1478, 1492 (9th Cir. 1996). At the pleadings stage, plaintiffs do not need to meet a strict test of direct causation; they need only show some causal nexus" between the defendants' misconduct and the plaintiffs' losses. *In re Controlled Data Corp. Sec. Litig.*, 933 F.2d 616, 619 (8th Cir. 1991).

Defendants argue that plaintiffs fail to show loss causation because there are no allegations that defendants' purported improper use of the POC accounting method caused or had any relation to the decline in value of plaintiffs' investment. Plaintiffs contend they have properly pled loss causation because they have alleged that the stock price on the date of purchase was inflated because of the misrepresentations or omissions and they would not have purchased the stock had they known about

defendants' wrongdoing with respect to their improper manipulation of the POC accounting method.

Here, plaintiffs do not point to any disclosure that Daou's revenue was improperly recognized under the POC accounting method. The SAC does not point to any announcement containing any negative information about defendants' accounting practices. Nor does the SAC explain how the alleged misrepresentations and/or omissions regarding the alleged improper use of the POC method "touched" upon the reasons for the decline in Daou's stock price. Accordingly, plaintiffs have not sufficiently alleged loss causation in their SAC.

CONCLUSION

The lack of a coherent structure to plaintiffs' SAC forces defendants and the court to piece together the various factual allegations found throughout the lengthy complaint in a way that reveals the legal underpinnings on which plaintiffs are attempting rely. In *In Re Petsmart, Inc. Securities Litigation*, 61 F. Supp. 2d 982 (D. Az. 1999), the Consolidated Amended Complaint recited the same allegations for every advance press release and subsequent SEC filing during the class period, with little differentiation. The Court chided the plaintiffs, stating that "the heightened pleading rules are designed to elicit clarity, not volume. The Court should not have to play connect-the-dots in order to identify the facts and trends upon which plaintiffs base their claim." *In Re Petsmart*, 61 F. Supp. 2d at 991. In *Wenger v. Lumisys, Inc.*, 2 F. Supp. 2d 1231, 1244 (N.D. Cal. 1998), the Northern District of California compiled a list of abuses found in securities fraud complaints in the hope that plaintiffs'

counsel would give "considered thought to efficient pleading and meaningful analysis." *Id.* n. 3. The cases cited by *Wenger* all disapprove of "puzzle-style" complaints, which require the defendants and the Court to sort out the alleged misrepresentations and match them with the corresponding adverse facts. *Id.* ("'The complaint as written requires the court to excavate for actionable claims. . . . Judicial resources are too scarce and worthy cases too pressing for a court to spend its time rooting around in bloated complaints drafted by experienced lawyers for a handful of actionable allegations.'"). The *Wenger* court also noted that "in contravention of the Reform Act, the plaintiff has failed to craft a Complaint in such a way that a reach can, without undue effort, divine why each alleged statement was false or misleading." *Id.*

In order to cure the problems in plaintiffs' SAC, plaintiffs must consolidate all the accounting issues and demonstrate where the accounting of the work in progress, costs incurred but not recognized, G&A as a percentage of revenue, cash balances, pooling of interest accounting, and differences in margins over the class period demonstrate the inflated income allegations that allegedly violate the POC accounting method or other GAAP principles during the class period. Plaintiffs must also show how these alleged violations related to the drop in the value of the stocks or the specific theory relied upon by plaintiffs. In addition, there must be at least some circumstantial showing or a strong inference of the true value compared with the inflated value of income that should have been reported by the Company. *See, In re Vantive Corp. Sec. Litig.*, 2002 WL 398498, *7 (9th Cir. March 15, 2002).

Based on the foregoing, **IT IS ORDERED** dismissing without prejudice plaintiffs' consolidated Second Amended

Complaint [doc. #91]. **IT IS FURTHER ORDERED** that plaintiffs shall file and serve a consolidated Third Amended Complaint no later than April 16, 2002. **Failure to file a Third Amended Complaint in conformity with this Order within the time provided shall result in this action being dismissed with prejudice without further notice to the parties.**

IT IS SO ORDERED.

Dated: 3/26/02 /s/ M. James Lorenz
M. James Lorenz
UNITED STATES
DISTRICT JUDGE

COPY TO:

HON. CYNTHIA G. AARON
UNITED STATES MAGISTRATE JUDGE

ALL COUNSEL

APPENDIX D

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF CALIFORNIA

In re DAOU SYSTEMS, INC. SECURITIES LITIGATION	Case No. 98-CV-1537-L (CGA)
This Order Relates to: ALL ACTIONS	**ORDER GRANTING DEFENDANTS' MOTION TO DISMISS CONSOLIDATED THIRD AMENDED CLASS ACTION COMPLAINT [Doc. No. 108]** (Filed Oct. 16, 2002)

Defendants move to dismiss Plaintiffs' Third Amended Class Action Complaint ("TAC") for failure to state a claim upon which relief may be granted. Plaintiffs oppose. Having fully reviewed the matters presented, the Court finds the matter suitable for submission without oral argument pursuant to Civil Local Rule 7.1.d.1 and enters the following decision.

I. Background

Plaintiffs bring this action on behalf of purchasers of shares of Daou Systems, Inc. ("Daou" or "the Company") between February 13, 1997 and October 28, 1998 ("the Class Period"). The underlying facts are summarized from the TAC and are assumed to be true for the purpose of this Order. *See Gompper v. VISX, Inc.*, 298 F.3d 893, 894 (9th Cir. 2002). Defendants are Chief Executive Officer and Chairman Georges Daou, President and Director Daniel

Daou, Chief Financial Officer and Senior Vice President Fred McGee, Chief Operating Officer and Executive Vice President Robert McNeill, Director John Moragne (collectively, "the Individual Defendants"), and the Company. Plaintiffs seek damages resulting from Defendants' allegedly fraudulent scheme and course of business during the Class Period. Plaintiffs contend that, prior to and during the Class Period, the Individual Defendants made false and misleading statements regarding the Company's accounting practices, revenue, earnings and business condition, and that these statements artificially inflated Daou's stock price.

Daou was a company that designed, implemented, supported and managed computer network systems for the health care field. Beginning with its initial public offering ("IPO"), Daou represented itself as an expanding and technologically astute company able to keep pace with the rapidly changing medical field. For the next seven quarters, the Company reported record and continuously growing revenues, and that its earnings per share would continue to exceed market analysts' published expectations. The Company also made public statements regarding successful employee training and retention and the benefits of the Company's "extremely strong pipeline position." *TAC* ¶ 2. As a result, Daou's stock price rose to a record high of nearly $35 per share in September 1997.

Plaintiffs allege that the Company's reports and public statements were false and misleading because they were based upon fraudulent accounting practices. The Company utilized an accounting method known as the percentage of completion ("POC") method. Plaintiffs contend that the POC method was manipulated and misused in order to artificially inflate the Company's

publicly reported revenue. Defendants allegedly recognized a significant percentage of a new contract's value as revenue immediately upon signing the contract and prior to any contract performance. "[D]efendants recognized millions of dollars in revenue before it was earned and without regard to actual labor costs incurred or total estimated labor costs." *TAC* ¶ 3. Plaintiffs further allege that the Company's statements regarding employee retention and the business pipeline were false. Daou was apparently experiencing high employee turnover, and the pipeline figures were based on projected revenue from contracts for which Daou had only made a bid or met with a prospective customer.

In August 1998, Daou began to experience deteriorating operating expenses and margins. On October 28, 1998 Daou revealed that it had fallen far short of its projected earnings for the third quarter of 1998. Daou also revealed that its work-in-progress account included over $10 million in unbilled receivables as a result of prematurely recognizing revenue. As a result of these disclosures, Daou's stock price fell to $3.25 per share.

Plaintiffs commenced several related actions in August 1998, which were later consolidated. On December 21, 1998 Plaintiffs filed their Consolidated Amended Class Action Complaint. Defendants subsequently moved to dismiss the Complaint, but the Court stayed the action pending the Ninth Circuit's ruling in *In re Silicon Graphics Securities Litigation*, a watershed decision in securities fraud pleading requirements. In January 2000, Plaintiffs filed the Consolidated Second Amended Class Action Complaint ("SAC").

By order dated March 27, 2002 the Court dismissed the SAC without prejudice and with leave to amend. The Court found that Plaintiffs did not meet the heightened pleading requirements for securities fraud litigation, described the SAC as "puzzle-style" and set forth with great specificity the measures Plaintiffs were to follow in order to cure the SAC's deficiencies.

> [P]laintiffs must consolidate all the accounting issues and demonstrate where the accounting of the work in progress, costs incurred but not recognized, G&A as a percentage of revenue, cash balances, pooling of interest accounting, and differences in margins over the class period demonstrate the inflated income allegations that allegedly violate the POC accounting method or other GAAP principles during the class period. Plaintiffs must also show how these alleged violations related to the drop in the value of the stocks or the specific theory relied upon by plaintiffs. In addition, there must be at least some circumstantial showing or a strong inference of the true value compared with the inflated value of income that should have been reported by the Company. *Order Granting Without Prejudice Defendants' Motion to Dismiss Consolidated Second Amended Class Action Complaint* (March 27, 2002) (hereinafter, "the March 27, 2002 Order") at 14 (citation omitted).

On May 16, 2002 Plaintiffs filed the TAC, bringing the following claims: (1) violation of Section 10(b) of the Exchange Act and Rule 10b-5, (2) violation of Section 20(a) of the Exchange Act, (3) violation of Section 11 of the Securities Act, (4) violation of Section 12(a)(2) of the Securities Act and (5) violation of Section 15 of the Securities Act. Defendants now move to dismiss the TAC, arguing that

Plaintiffs have failed to cure the TAC of the previous complaints' shortcomings.

II. Legal Standard

Rule 12(b)(6) of the Federal Rules of Civil Procedure allows a court to dismiss a complaint upon a finding that the plaintiff has failed to state a claim upon which relief may be granted. Fed. R. Civ. P. 12(b)(6). A 12(b)(6) motion tests a complaint's legal sufficiency. *See, e.g. Navarro v. Block*, 250 F.3d 729, 732 (9th Cir. 2001). Dismissal is proper only where the plaintiffs complaint lacks a cognizable legal theory or sufficient facts to support a cognizable legal theory. *See id.* "[I]f as a matter of law 'it is clear that no relief could be granted under any set of facts that could be proved consistent with the allegations,' a claim must be dismissed whether it is based on an outlandish legal theory or a close but ultimately unavailing one." *Neitzke v. Williams*, 490 U.S. 319, 326-27 (1989) (citations omitted). Thus, a court should not dismiss a complaint "unless it appears beyond doubt that plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957); *see also Parks School of Business, Inc. v. Symington*, 51 F.3d 1480, 1484 (9th Cir. 1995). Finally, the court must accept the complaint's allegations as true and construe the complaint in the light most favorable to the plaintiff. *See Cahill v. Liberty Mutual Ins. Co.*, 80 F.3d 336, 338 (9th Cir. 1996).

III. Discussion

Defendants base their motion to dismiss the TAC on three arguments: (1) Plaintiffs have not pled with sufficient specificity which statements made by each defendant

were materially false, (2) Plaintiffs have not pled particularized facts creating a strong inference of scienter on the part of any defendant and (3) Plaintiffs have not demonstrated a causal nexus between any allegedly misleading statements and the decline in value of Plaintiffs' stock. *See Defs.' Mem. of P. & A.* at 1. Defendants maintain that these flaws are fatal to each of Plaintiffs' claims.

A. Failure to State a Claim Under Section 10(b) and Rule 10b-5

1. Pleading Requirements for Section 10(b) and Rule 10b-5

Section 10(b) of the Exchange Act proscribes the use of any deceptive device in connection with the purchase or sale of securities in contravention of rules prescribed by the Securities and Exchange Commission. *See* 15 U.S.C. § 78j(b). "The provision, as written, does not confine its coverage to deception of a purchaser or seller of securities . . . rather, the statute reaches any deceptive device used in connection with the purchase or sale of any security." *United Slates v. O'Hagan*, 521 U.S. 642, 651 (1997) (internal citations omitted). Rule 10b-5 provides in relevant part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, . . . [t]o employ any device, scheme, or artifice to defraud, [or] [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person . . . in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5. To state a claim under Section 10(b) and Rule 10b-5, a plaintiff must allege (1) a misstatement or omission (2) of material fact (3) made with Scienter (4),on which the plaintiff relied and (5) which proximately caused the plaintiff's injury. *See DSAM Global Value Fund v. Altris Software, Inc.*, 288 F.3d 385, 388 (9th Cir. 2002).

In December 1995 Congress enacted the Private Securities Litigation Reform Act of 1995 ("PSLRA"), which mandates that complaints alleging securities fraud must meet the heightened pleading standards of both the PSLRA and Rule 9(b) of the Federal Rules of Civil Procedure. *See In re Vantive Corp. Sec. Litig.*, 283 F.3d 1079, 1091 (9th Cir. 2002). Rule 9(b) provides that "in all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally." Fed. R. Civ. P. 9(b). Through the PSLRA, Congress clarified and strengthened the particularity requirements of Rule 9(b) as applied in the context of federal securities class action lawsuits. The resulting standard requires that a securities fraud plaintiff shall identify (1) each statement alleged to have been misleading, (2) the reason or reasons why the statement is misleading and (3) all facts on which that belief is formed. *Desaigoudar v. Meyercord*, 223 F.3d 1020, 1023 (9th Cir. 2000), *cert. denied*, 532 U.S. 1021 (2001) (citing *In re Silicon Graphics*, 183 F.3d 970, 996 (9th Cir. 1999)).

Scienter is a "mental state embracing intent to deceive, manipulate, or defraud," *Wharf Holdings Ltd. v. United Int'l Holdings, Inc.*, 532 U.S. 588, 593 (2001) (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976)). With regard to this element, the PSLRA requires

complaints alleging federal securities fraud to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). This language requires the plaintiff to "plead, in great detail, facts that constitute strong circumstantial evidence of deliberately reckless or conscious misconduct" *Silicon Graphics*, 183 P.3d at 974. Finally, if the plaintiff fails to satisfy the pleading requirements set forth in the Federal Rules and the PSLRA, the latter provides that "the court shall, on the motion of any defendant, dismiss the complaint[.]" 15 U.S.C. § 78u-4(b)(3)(A).

2. Accounting Fraud

Defendants first argue that the TAC does not contain sufficiently particularized allegations regarding the Company's allegedly fraudulent accounting practices. Specifically, Defendants contend that Plaintiffs do not sufficiently allege how the accounting practices in question violate Generally Accepted Accounting Practices ("GAAP") and the Company's stated accounting practice, or why they were materially misleading.

The Company's POC accounting method is a valid accounting method on all fours with GAAP. Under the POC method,

> revenue from [the Company's] long-term network system contracts could only be recognized based on the percentage of labor costs incurred to date compared to total estimated labor costs for the project. Under GAAP, defendants . . . were required to recognize revenue in line with a reasonable and defensible degree of accuracy based on a comprehensive review of each contract.

TAC ¶ 3. The essence of Plaintiffs' accounting fraud claim is that Defendants manipulated their POC accounting method by fraudulently recognizing revenue before it was earned and/or before the Company was entitled to record the revenue. Plaintiffs identify three areas in which Defendants' revenue recognition allegedly deviated from GAAP and the POC method: (1) Defendants recognized up to 50% of the total value of new contacts immediately upon signing the contracts and before any significant labor costs had been incurred, (2) Defendants knowingly inflated the percentage of labor costs incurred and (3) Defendants knowingly underestimated projections of total labor costs needed to complete ongoing contracts. *TAC* ¶¶ 27-30. Plaintiffs then list various methods by which Defendants allegedly achieved their premature revenue recognition under the POC method, after which they allege how these actions violated GAAP. *See TAC* ¶¶ 24-31, 34.

A review of the TAC reveals that it contains largely the same allegations seen in the SAC, albeit organized differently and with additional allegations regarding confidential witnesses' accounts of the goings-on at Daou. In the March 27, 2002 Order, the Court listed the precise allegations the TAC must include in order to state a claim for securities fraud. The Court specifically stated, "[P]laintiffs do not allege how much revenue should have been recognized under the POC method and do not calculate the specific amount of revenue that defendants allegedly improperly recognized; therefore, it is impossible to infer from the SAC that any revenue was improperly recognized." *Order* at 7.

The Court finds the TAC equally deficient. Plaintiffs have merely repackaged the same allegations regarding revenue recognition that were ruled inadequate in the

SAC. When pleading revenue recognition irregularities, plaintiffs should allege "basic details such as the approximate amount by which revenues and earnings were overstated," "the dates of any of the transactions," "or the identities of many of the customers or employees involved in the transactions." *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 204 (1st Cir. 1999). In the TAC, Plaintiffs do identify some customers and dates related to transactions which allegedly gave rise to improper revenue recognition. However, despite an exhaustive search of the TAC, the Court was unable to locate and identify any allegations quantifying and contrasting the revenue Defendants *actually* recognized under the POC method and the revenue Defendants *should have* recognized if they had properly applied the POC method. This information is essential to surviving a motion to dismiss in this context. In a similar case, a federal district court upheld allegations of premature revenue recognition where the complaint included an actual monetary measure of the discrepancy between proper and improper revenue recognition. *See In re Raytheon Sec. Litig.*, 157 F.Supp.2d 131, 140-141 (D.Mass. 2001). In *Raytheon*, as in the instant case, the plaintiffs alleged that the defendants "caused the premature booking of costs on several of its long-term contracts in order to accelerate the recognition of profits. Under the percentage-of-completion accounting method, prematurely booked costs allowed [the defendants] to book the corresponding revenues and profits." *Id.* at 140. However, the plaintiffs were able to provide a list of contracts and the specific amount of costs accelerated on each contract, thereby demonstrating the actual dollar amount of improperly recognized revenue. *Id.* From this quantified discrepancy, the court was able to infer that the defendants had acted improperly.

Here, however, and as the Court discussed in the March 27, 2002 Order, merely stating that in some instances Defendants recognized up to 60% of POC revenue before they were entitled to do so, and describing ways by which Defendants achieved this result, is insufficient. Plaintiffs must allege how Defendants should properly have applied the POC method relative to each contract – it is not enough to state that, in each transaction, Defendants violated basic accounting principles under GAAP and the POC method. "A general allegation that the practices at issue resulted in a false report of company earnings is not a sufficiently particular claim of misrepresentation." *In re Peerless Systems, Corp. Sec. Litig.*, 182 F.Supp.2d 982, 991 (S.D. Cal. 2002) (Lorenz, J.) (quoting *Gross v. Summa Four, Inc.*, 93 F.3d 987, 996 (1st Cir. 1996)). Although Plaintiffs' attempt to cure this deficiency by mentioning specific instances of alleged fraud involving a handful of contracts with certain customers, these examples again do not identify with any particularity the variance between proper application of the POC method and Defendants' alleged manipulation of the POC method.

While Plaintiffs do allege specific amounts of allegedly overstated revenue, they immediately go on to allege that the overstatement can be accounted for in each financial quarter with corresponding amounts in Daou's work in progress account.[1] However, the TAC is bereft of allegations

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[1] *See, e.g. TAC* ¶ 45(d). "Had Daou reported revenue in line with the amount it was entitled to bill customers pursuant to its contracts, actually reflecting contact work done to data, revenue would have been only 54.1 million, 21% less than publicly reported ($5.2 million) . . . the dramatic growth in Daou's work in progress account, increasing $1.1 million from 4Q96 to 1Q97, was the result of defendants' premature recognition of revenue."

explaining *why* recognizing revenue before it is earned and booking that amount of revenue in the Company's work in progress account is fraudulent or misleading. Defendants argue that "fraud requires deception, and Daou made no secret of the variance between revenue and billing . . . in every instance, the Work in Progress on Daou's Balance Sheet increased by an amount that corresponded with the alleged variance between the revenue recognized by the Company and what hindsight demonstrates was the actual percentage of completion." *Defs.' Mem. of P. & A.* at 6. The Court agrees that, as alleged, this practice is not demonstrably misleading. Indeed, Daou's February 1997 prospectus and registration statement outline the Company's accounting policy, describing the interaction between the POC method and the work in progress account. "'Certain contract payment terms may result in customer billing occurring at a pace slower than revenue recognition. The resulting revenue recognized in excess of amounts billed and project costs are classified as contract work in progress.'" *TAC* ¶ 44. Moreover, the Company's 10-K for fiscal year 1997 sets forth the amount of revenue booked under the POC method and the corresponding balance in the work in progress account. *Defs.' Notice of Lodgment* Exh. 3 at 148. This information was therefore available to financial and market analysts at the time it was published; notably, the 10-K did not arouse any suspicions at that time. Finally, when Daou's financial woes were revealed in August 1998, analysts and investors focused their attention on the Company's reported versus actual merger-related expenses – their suspicions did not center on Daou's revenue recognition methods. See TAC ¶¶ 78-84.

In sum, Plaintiffs appear that argue that, because there was a variance between recognized and earned revenue, Defendants must have been engaged in accounting fraud. Their allegations that the funds in the work in progress account represented improperly recognized revenue are conclusory and appear to result from circular logic. Plaintiffs simply have not shown that recognizing unearned revenue and earmarking it for the work in progress account is anything but an exercise of Defendants' business judgment. Plaintiffs have not shown how following this practice is improper. Without more, the Court must conclude that Plaintiffs have not pleaded their accounting fraud claims with sufficient particularity to pass PSLRA muster.

3. False and Misleading Public Statements

Plaintiffs next allege that Defendants repeatedly made false and misleading public statements in order to artificially inflate the Company's stock price. Plaintiffs contend that Defendants sought to boost the stock price so that they could make certain corporate acquisitions. They list a lengthy summary of statements by Defendants that were allegedly false and misleading:

- Daou's IPO prospectus was false and misleading because it set forth the POC method as one of Daou's accounting methods, but Defendants had manipulated the POC method in the quarter prior to the IPO and misrepresented financial results in the prospectus. *TAC* ¶¶ 44-46.

- Daou's April 1997 press release announcing its first quarter (1Q97) financial results and Defendants' later statements attributing those results to "strong growth" were false and misleading due to Defendants'

improper revenue recognition under the POC method. *TAC* ¶¶ 47-49.

- Daou's July 1997 announcement of its second quarter (2Q97) financial results in the *Business Wire* and Defendants' later statements regarding "strong business momentum" and "better than expected 2Q results" were false and misleading due to Defendants' improper revenue recognition under the POC method. *TAC* ¶¶ 50-52.

- Daou's August 1997 Registration Statement and Prospectus offering shares of common stock was false and misleading because it represented that the Company would utilize the POC method, yet Defendants allegedly were already recognizing revenue improperly. The Registration Statement and Prospectus were also misleading in that they included the false 1Q97 and 2Q97 financial results. *TAC* ¶¶ 53-54.

- Daou's October 1997 announcement of its third quarter (3Q97) financial results in the *Business Wire* reporting "record" revenue and earnings, and Defendants' later statements that the 3Q97 results "had well exceeded analyst estimates" were false and misleading due to Defendants' improper revenue recognition under the POC method. *TAC* ¶¶ 57-59.

- Daou's January 1998 announcement of its fourth quarter (4Q97) and year-end (FY97) financial results in the *Business Wire* reporting "record" 4Q97 results, an "outstanding year," and Defendants' later statements that "the outlook for the Company had never been brighter" were false and misleading due to Defendants' improper revenue recognition under the POC method. *TAC* ¶¶ 60-62.

- Daou's April 1998 announcement of its first quarter (1Q98) financial results in the *Business Wire* and Defendants' subsequent statement that "although contract work-in-progress increased to $20.1 million this was no cause for concern as unbilled receivables represented only $900,000 of this amount and the rest was hardware purchased and labor hours for which no revenue had been recognized" was false and misleading due to Defendants' improper revenue recognition under the POC method. *TAC* ¶¶ 64-66.

- Daou's July 1998 announcement of its second quarter (2Q98) financial results in the *Business Wire,* and Defendants' later statements reporting "record" results and attributing those results to the Company's "leveraging of its operating expenses" and "strong demand" were false and misleading due to Defendants' improper revenue recognition under the POC method. *TAC* ¶¶ 67-69.

- Daou's statements regarding its hiring and retention of qualified employees, and its training of those employees through "Daou University" (the Company's employee training program) were false and misleading because Daou had high employee turnover and was having difficulty attracting and retaining qualified employees, and Daou University did not exist. *TAC* ¶¶ 71-74.

- Daou's positive statements regarding its customers, contracts, pipeline and backlog were false and misleading because these statements were not reinforced by contractual demand and were highly speculative. *TAC* ¶¶ 75-77.

Plaintiffs contend that Daou's true state of affairs was revealed in August 1998, when the Company filed its 10-Q form with the SEC reporting figures that were vastly different than those reported in its July 1998 press release

and subsequent public statements. "Defendants failed to disclose the actual figures to analysts to conceal the fact that Daou's operating earnings and margins were deteriorating as a result of prematurely and improperly recognizing revenue," *TAC* ¶ 78.

Allegations of false material statements or omissions must specify (1) each statement alleged to have been misleading, (2) the reason or reasons why the statement is misleading and (3) if an allegation is made on information and belief, the complaint must state with particularity all facts upon which that belief is based. 15 U.S.C. § 78u-4(b)(1). Additionally, if scienter is an element of the claim, the complaint must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). If the alleged material statement or omission is a forward-looking statement, the required level of scienter is actual knowledge of the statement's falsity. *See Ronconi v. Larkin*, 253 F.3d 423, 429 (9th Cir. 2001) (citing 15 U.S.C. § 78u-5(c)(1)).

The crux of Plaintiffs' claims that these statements were false and material is that Defendants manipulated the POC method in order to defraud the public and inflate the Company's stock price. Defendants argue that Plaintiffs fail to demonstrate how Daou's accounting practices violated GAAP, and how these accounting judgments resulted in material misrepresentations. The Court previously found the SAC's allegations of false and misleading statements unacceptable because the allegations did not comport with § 78u's requirements, and that the factual statements intended to reinforce the allegations were unsupported, conclusory and vague. *See March 27, 2002 Order* at 9. In the TAC, Plaintiffs remedy these

problems somewhat – each of the allegedly false statements listed above is accompanied by an explanation of why the statement was false and how Defendants allegedly knew the statement was false.

The TAC relies heavily on the accounts of confidential witnesses[2] to support the allegations that Defendants' statements were false. The allegations based upon the confidential witnesses' accounts are substantially the same for each false statement:

- "CW5 . . . confirmed that defendants would automatically record 20% of the revenue from a contract upon contract signing, prior to any labor costs being incurred. Forty percent of the revenue from contracts was recognized immediately after any equipment was ordered and 50-60% of the revenue was recognized as soon as the equipment was "burned in" (configured and tested). CW5 confirmed that this revenue was recognized without regard to labor costs incurred." *TAC* ¶¶ 45(a), 51(a), 58(a), 61(a), 65(a), 68(a).

- "CW28 . . . confirmed that a fixed amount of revenue was recognized on contracts immediately upon signing, and that the revenue reported by defendants did not reflect labor costs incurred compared to total estimated labor costs . . . CW9 further confirmed the accuracy of CW5 and CW28 reports[.]" *TAC* ¶¶ 45(b), 51(b), 58(b), 61(b), 65(b), 68(b).

- CW8 and CW3 "both confirmed that it was known throughout Daou at this time that [Defendants] G. Daou, D. Daou and McNeill were engaged in improper

[2] The *TAC* has assigned a number to each confidential witness ("CW"), e.g. CW1, CW2 and so forth, and includes a description of the witness' position and duties at Daou.

revenue recognition . . . According to CW3, CW5, CW9 and CW28, this premature and improper revenue recognition – violating GAAP and Daou's stated accounting policy . . . was true for all or virtually all Daou projects." *TAC* ¶¶ 45(c), 51(c), 58(c), 61(c), 65(c), 68(c).

- "CW13, CW17 and CW27 confirmed that the dramatic growth in Daou's work in progress account . . . was the result of defendants' premature recognition of revenue." *TAC* ¶¶ 45(d), 51(d), 58(d), 61(d), 65(d), 68(d).

- "According to CW12 and CW28 . . . the estimates of total labor costs provided by senior managers at project sites were routinely ignored for revenue recognition purposes. The estimates of total labor hours used to calculate revenue by defendants G. Daou, D. Daou, McNeill and McGee were, according to CW12, grossly understated and did not reflect the opinions of the on-site managers." *TAC* ¶¶ 45(f), 51(h), 58(h), 61(j), 65(j), 68(h).

- "CW2 . . . reported that he was specifically told by both a senior-level network engineer and a Field Services project manager that defendants' revenue recognition on their projects was improper and was not based on Daou's stated accounting policy." *TAC* ¶¶ 45(g), 51(j), 58(j), 61(l), 65(l), 68(j).

- "[A]ccording to CW3 and CW24, project managers were told that projects were 'closed' for billing purposes, when the projects were actually far from completion." *TAC* ¶¶ 45(h), 51(i), 58(i), 61(k), 65(k), 68(i).

The confidential witnesses' statements thus cover familiar and redundant ground. For each allegedly false statement listed in the TAC, Plaintiffs rely on their claims that Defendants improperly recognized revenue to support their claim that the statement was false and misleading.

The Court finds that the allegations regarding improper use of the POC method are insufficient factual support for Plaintiffs' claims of false statements. The alleged GAAP violations with respect to some individual contracts come in through these witnesses. However, as discussed above, Plaintiffs have not adequately alleged that Defendants misused the POC method, because they have not quantified how Defendants' alleged misuse varied from proper use of the POC method. The confidential witnesses' "confirmations" do not improve upon this defect – their statements are largely conclusory assertions that Defendants' use of the POC method violated GAAP.

Moreover, the confidential witnesses are not entirely reliable sources. Actions and statements attributed to Defendants through these witnesses are often second and third-hand and/or rely on unnamed sources. Further, in most of these instances, it is unclear how the witnesses' came to learn of the information they provided. The PSLRA requires that such allegations be pleaded with substantial specificity. *In re Northpoint Communications Group, Inc. Sec. Litig.*, 184 F.Supp.2d 997, 1000 (N.D. Cal. 2001) (discussing the use of confidential witnesses in securities fraud pleadings). Plaintiffs cannot establish factual support for their allegations with, witness statements asserting, for example, that Defendants' improper revenue recognition "was known throughout Daou." *See, e.g. TAC* ¶ 68(c). Similarly, in many of the allegations, the witnesses "confirm" Plaintiffs' conclusory statements that Defendants improperly recognized revenue. Again, Plaintiffs do not adequately allege a basis for these confirmations.

With respect to Plaintiffs' assertions that Defendants' statements regarding contracts, business pipeline and

backlog were false and misleading, the Court finds that these statements are not actionable. The TAC quotes several statements made by Defendants to the effect that backlog and pipeline position were "extremely strong," "remained healthy and would fuel future earnings growth," "visibility was excellent," and the Company's "momentum was increasing." *TAC* ¶ 75. These statements also included relevant backlog and pipeline amounts. Plaintiffs contend these statements were false because they were not based on actual contractual demand and were highly speculative – they allege that the pipeline report did not reflect contracts Daou would actually get and that the likelihood of repeat business was low. *TAC* 76. The Court finds these allegations vague and speculative. Moreover, with respect to the pipeline report, Plaintiffs were able to state only with the benefit of hindsight that the report was based on contracts the Company eventually did not receive. This indicates that the pipeline statements were likely not false when made.

Finally, Defendants argue that Plaintiffs' allegations regarding the falsity of Defendants' statements about employee hiring, training and retention are not actionable. Between August 1997 and July 1998, Defendants made several statements to analysts, investors and shareholders on the subject, such as that Daou had "state-of-the-art training policies," was "successfully retaining employees," "was not having problems with employee turnover," and that "employee turnover remained very low and attrition within the technical ranks of employees was only 6.8%." *TAC* ¶ 71. Plaintiffs contend that despite the rosy picture Daou painted, in actuality, employee attrition was high, the Company was having difficulty retaining qualified employees, and that it was sending unqualified personnel

to job sites. *TAC* ¶ 73. The Court finds that the majority of Defendants' statements regarding personnel resources are sufficiently vague as to be inconsequential. The one allegation of any substance, Plaintiffs' contention that employee attrition was actually 40%, not 6.8% as represented by Defendants, does not establish misrepresentation on Defendants' part. Defendants' statement that attrition among *technical* employees was at 6.8% was made in July 1998, and confidential witnesses' statements that the attrition rate for *all* employees was at 40% was made in the first quarter of 1998. Moreover, Plaintiffs have not demonstrated that any of the above statements were material to any shareholders' and investors' decisions to purchase Daou stock. In sum, the Court concludes that Plaintiffs have not sufficiently alleged that Defendants made any actionable false or misleading statements.

4. Scienter

Defendants further argue that Plaintiffs have not adequately pled the required level of scienter. To establish the requisite scienter, Plaintiffs allege that (1) Defendants had actual knowledge of the negative information contained in internal financial reports, (2) Defendants had actual knowledge of the misuse of the POC method and (3) Defendants engaged in insider trading. In its previous order, the Court concluded that Plaintiffs had not established that Defendants had actual knowledge that their statements regarding Daou's financial status were false when made.

The PSLRA requires plaintiffs to plead, at minimum, particular facts giving rise to a strong inference of deliberate or conscious recklessness. *Silicon Graphics,* 183 F.3d

at 979. Pleading scienter in general terms of mere "motive and opportunity" or "recklessness" fail to meet the PSLRA's heightened pleading requirements. *Id.* at 974. *Cf. Lipton v. Pathenogenesis Corp.*, 284 F.3d 1027, 1038 (9th Cir. 2002) (plaintiffs must go beyond alleging that "officers and directors possess motive and opportunity to enhance a company's business prospects[.]").

Plaintiffs first focus on Defendants' alleged improper revenue recognition as the basis for their scienter argument. They contend that, because Defendants purposely manipulated revenue recognition under the POC method, Defendants knew that Daou's quarterly financial results, as reported to market analysts, were false. However, as discussed above, Plaintiffs have not adequately alleged that Defendants engaged in fraudulent revenue recognition by way of the POC method. These allegedly fraudulent accounting practices therefore cannot properly form the basis for allegations that Defendants knew their financial reports were false. Although the TAC includes statements from confidential witnesses corroborating the ways in which Defendants recognized revenue under the POC method, the failure to establish misuse of the POC method is fatal to Plaintiffs' scienter allegations. Similarly, Plaintiffs' contention that Defendants demonstrated the required level of scienter by making corporate acquisitions also fails, because this theory was also based upon Plaintiffs' allegations that Defendants fraudulently and purposefully inflated Daou's stock price through misuse of the POC method. The TAC includes new allegations quantifying Daou's cash flow difficulties and specifying the number of shares Defendants saved by allegedly inflating Daou's stock price.

> [A]s of June 30, 1997, Daou had only $14.5 million in cash and was experiencing net losses for the second straight quarter since the Company's IPO. Because Daou needed to conserve its cash to fund ongoing operations it had to use stock for acquisitions. Using Daou stock to pay for acquisitions, however, meant that it was of critical importance . . . to report profitable growth and a strong financial condition to keeps its stock price at high levels . . . if defendants had not artificially inflated the price of Daou's stock, they would have had to issue an additional 19.6 million shares to complete the acquisitions. *TAC* ¶ 39-40.

Without viable allegations that Defendants improperly recognized revenue, the allegation that Defendants abused the POC method to increase their ability to pay for acquisitions is merely speculative.

Next, Plaintiffs allege that Defendants engaged in insider trading. They contend that Defendants made suspiciously fortuitous sales of Daou stock, garnering millions of dollars from these transactions. Plaintiffs further allege that Defendants' friends and immediate family also sold significant holdings of Daou stock during the same time period. Plaintiffs argue that these stock transactions indicate that Plaintiffs were knowingly engaging in fraudulent business practices intended to boost Daou's stock price. Collectively, the proceeds from Defendants' stock sales totaled $30.5 million, and Defendants' friends' and family members' sales totaled approximately $18 million.

"A strong inference of fraudulent intent may occur when an insider 'owning much of a company's stock make[s] rosy characterizations of company performance to

the market while simultaneously' selling large percentages of his holdings." *Lipton*, 284 F.3d at 1036-37 (quoting *Ronconi*, 253 P.3d at 434). "[I]nsider trading is suspicious only when it is dramatically out of line with prior trading practices at times calculated to maximize the personal benefit from undisclosed information ... Among the relevant factors to consider are: (1) the amount and percentage of shares sold by insiders; (2) the timing of the sales; and (3) whether the sales were consistent with the insider's prior trading history." *Silicon Graphics*, 183 F.3d at 986 (citations and internal quotations omitted).

Here, Plaintiffs point to the timing of the sales and the amounts sold as suggestive of Defendants' fraudulent intent. Four of the five individual Defendants sold shares on August 15, 1997, and three of the five sold additional shares on January 29, 1998. Defendants Georges and Daniel Daou each sold 28% of their holdings, Defendant McGee sold 80% of his holdings, Defendant McNeill sold 67% of his holdings, and Defendant Moragne sold 43% of his holdings. After reviewing the TAC, the Court finds that it contains substantially the same allegations regarding insider trading deemed inadequate in the SAC. Moreover, the Court notes that the majority of Defendants' sales coincided with Daou's secondary public offering because they were precluded from selling shares before then, and further notes that most of the Defendants retained significant holdings in the Company and thus incurred the most substantial losses when the stock price eventually dropped. These two factors weigh against an inference of wrongdoing. Plaintiffs have not adequately demonstrated that Defendants engaged in insider trading in a manner "calculated to maximize [their] personal benefit." *Silicon Graphics*, 183 F.3d at 986. In sum, the Court concludes

that Plaintiffs have not sufficiently pled that Defendants had actual knowledge of their alleged fraudulent activity.

5. Causation

Next, Defendants argue that Plaintiffs have not adequately alleged loss causation. A plaintiff asserting a federal securities fraud claim must plead and prove causation; namely, the causal connection between defendant's misrepresentation and plaintiff's injury. *Ambassador Hotel Co., Ltd. v. Wei-Chuan Investment,* 189 F.3d 1017, 1027 (9th Cir. 1999) (citing *Basic Inc. v. Levinson,* 485 U.S. 224, 243 (1988)). The plaintiff must prove both transaction causation, that the violations in question caused the plaintiff to engage in the transaction, and loss causation, that the misrepresentations or omissions caused the harm. *Id.* Congress recently made the loss causation element an explicit requirement in private federal securities fraud actions: "In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4). To prove loss causation, the plaintiff must demonstrate a causal connection between the deceptive acts that form the basis for the claim of securities fraud and the injury suffered by the plaintiff. *Ambassador Hotel,* 189 F.3d at 1027. The causation requirement is satisfied in a Rule 10b-5 case only if the misrepresentation touches upon the reasons for the investment's decline in value. *See Binder v. Gillespie,* 184 F.3d 1059, 1066 (9th Cir. 1999), *cert. denied sub nom. Binder v. Wilson,* 528 U.S. 1154 (2000). Thus, the loss causation requirement limits the ability of plaintiffs to recover for losses sustained on the

basis of factors unrelated to any misrepresentation or fraud. *Ambassador Hotel,* 189 F.3d at 1027.

Defendants contend that Plaintiffs cannot successfully allege loss causation because the Company's allegedly improper use of the POC method was not linked to the decline in Daou's share price. Plaintiffs counter that they "have pled how defendants' admissions in August and October 1998, revealing lower than expected earnings, revenue losses and extremely poor results for 3Q98, were the results of defendants' 18 month fraud." *Pls.' Opp'n* at 23. The Court disagrees. It is undisputed that Daou's 3Q98 financial results were dismal, and that this led to the precipitous drop in the Company's stock value. However, in the TAC, Plaintiffs have not adequately been able to link the decline in share price to any purported improper revenue recognition by Defendants. Plaintiffs point to the fact that market analysts questioned whether Defendants had been "cooking" Daou's books after the 3Q98 results were revealed, but this is merely speculation. Notably, the TAC does not allege that there were any negative public statements, announcements or disclosures at the time the stock price dropped that Defendants were engaged in improper accounting practices. Plaintiffs' allegations simply have not been able to bridge the gap between what may have been poor business judgment by Defendants and any actual wrongdoing by Defendants. Thus, they cannot allege that Defendants' alleged abuse of the POC method caused the decline in stock value, thereby injuring Plaintiffs.

B. Failure to State a Claim Under the Securities Act of 1933

Plaintiffs further allege that Defendants violated sections 11 and 12 of the Securities Act. Liability under § 11 of the Securities Act attaches if "any part of the registration statement, when such part becomes effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading." 15 U.S.C. § 77k(a). "The plaintiff in a § 11 claim must demonstrate (1) that the registration statement contained an omission or misrepresentation, and (2) that the omission or misrepresentation was material, that is, it would have misled a reasonable investor about the nature of his or her investment." *In re Stac Elecs. Sec. Litig.*, 89 F.3d 1399, 1403-04 (9th Cir. 1996) (citations omitted), *cert. denied*, 520 U.S. 1103 (1997). No scienter is required for § 11 liability. *Id.* at 1404.

Here, Plaintiffs allege that the Company's February 13, 1997 prospectus and registration statement are false and misleading. Defendants argue that it would be impossible for Plaintiffs to prevail on these claims because the prospectus and registration statement are facially true. The Court agrees. Plaintiffs take issue with the language in the prospectus and registration statement which names the POC method as Defendants' accounting policy and describes how revenue will be recognized using this method. Plaintiffs allege that these statements are false and misleading because Defendants manipulated and abused the POC method. As detailed above, these allegations must fail, as Plaintiffs have not sufficiently alleged that Defendants improperly recognized revenue. The

Court concludes that Plaintiffs have failed to state a claim under § 11.

Section 12(a)(2) imposes civil liability on any person for use of any instrumentality of interstate commerce to offer or sell securities by means of a prospectus or oral communication that includes "an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading." 15 U.S.C. § 771(a)(2). To establish liability under § 12(a)(2), a plaintiff must allege that the defendants actively solicited purchase of the securities for their own financial motives. *In re Stratosphere Corp. Sec. Litig.*, 1 F.Supp.2d 1096, 1120 (D.Nev. 1998) (citing *Pinter v. Dahl*, 486 U.S. 622, 646-48 (1988)).

Defendants argue that Plaintiffs' § 12(a)(2) claim must fail because Plaintiffs cannot plead and prove that Defendants were directly involved [sic] actual solicitation of a securities purchase. The Court need not reach this argument, as Plaintiffs' 12(a)(2) claim necessarily rails for lack of adequate allegations that Defendants made any false or misleading statements or omissions of material fact.

C. Failure to State a Claim for Control Person Liability

Section 15(a) of the Securities Act imposes joint and several liability upon every person who controls any person liable under sections 11 or 12. 15 U.S.C. § 77o. To state a claim for control person liability under § 15, a plaintiff must allege that the individual defendants had the power to control or influence the company, and that the individual defendants were culpable participants in

the company's alleged illegal activity. *See Durham v. Kelly*, 810 F.2d 1500, 1503 (9th Cir. 1987). Similarly, section 20(a) of the Exchange Act imposes joint and several liability on any person who directly or indirectly controls any person liable for securities fraud unless the controlling person acted in good faith and did not directly or indirectly induce the violations. *See Allison v. Brooktree Corp.*, 999 F.Supp. 1342, 1355 (S.D. Cal. 1998) (Miller, 5.) In order to state a claim for control person liability, Plaintiffs must allege actual power or influence over the company. *Id.* (citations omitted). However, because Plaintiffs have failed to state viable claims for relief under sections 10(b), 11 or 12(a)(2), their sections 11(a) and 20(a) claims also fail.

IV. Conclusion and Order

Plaintiffs' failure to amend the SAC to cure the deficiencies as specified in this Court's March 27, 2002 Order is fatal to their case. The Order stated that "[f]ailure to file a Third Amended Complaint in conformity with this Order within the time provided shall result in this action being dismissed with prejudice without further notice to the parties. The Court concludes that Plaintiffs' TAC fails to state a claim upon which relief may be granted. Accordingly, the Court GRANTS Defendants' motion to dismiss the TAC with prejudice.

IT IS SO ORDERED.

Dated: 10/15/02

/s/ M. James Lorenz
M. JAMES LORENZ
UNITED STATES
DISTRICT JUDGE

cc: Hon. Cynthia G. Aaron
United States Magistrate Judge

All parties and counsel of record

APPENDIX E

United States District Court

SOUTHERN DISTRICT OF CALIFORNIA

Brody	**JUDGMENT IN A CIVIL CASE**
v.	**CASE NUMBER:** 98cv1537L(CGA)
Daou Systems Inc	(Filed Oct. 16, 2002)

☐ **Jury Verdict.** This action came before the court for a trial by jury. The issues have been tried and the jury has rendered its verdict.

☒ **Decision by Court.** This action came to trial or hearing before the Court. The issues have been tried or heard and a decision has been rendered.

IT IS ORDERED AND ADJUDGED that the court grants defendants' motion to dismiss the third amended class action complaint with prejudice.

October 16, 2002
Date

W. Samuel Hamrick, Jr.
Clerk

B. Robinson /s/ B. Robinson
(By) Deputy Clerk
ENTERED ON October 16, 2002

United States District Court

SOUTHERN DISTRICT OF CALIFORNIA

Katsman	**JUDGMENT IN A CIVIL CASE**
v.	**CASE NUMBER:** 98cv1575L(CGA)
Daou Systems Inc	(Filed Oct. 16, 2002)

☐ **Jury Verdict.** This action came before the court for a trial by jury. The issues have been tried and the jury has rendered its verdict.

☒ **Decision by Court.** This action came to trial or hearing before the Court. The issues have been tried or heard and a decision has been rendered.

IT IS ORDERED AND ADJUDGED that the court grants defendants' motion to dismiss the third amended class action complaint with prejudice.

October 16, 2002
Date

W. Samuel Hamrick, Jr.
Clerk

B. Robinson /s/ B. Robinson
(By) Deputy Clerk
ENTERED ON October 16, 2002

United States District Court

SOUTHERN DISTRICT OF CALIFORNIA

Zuckerman	**JUDGMENT IN A CIVIL CASE**
v.	**CASE NUMBER:** 98cv1657L(CGA)
Daou Systems Inc	(Filed Oct. 16, 2002)

☐ **Jury Verdict.** This action came before the court for a trial by jury. The issues have been tried and the jury has rendered its verdict.

☒ **Decision by Court.** This action came to trial or hearing before the Court. The issues have been tried or heard and a decision has been rendered.

IT IS ORDERED AND ADJUDGED that the court grants defendants' motion to dismiss the third amended class action complaint with prejudice.

October 16, 2002
Date

W. Samuel Hamrick, Jr.
Clerk

B. Robinson /s/ B. Robinson
(By) Deputy Clerk
ENTERED ON October 16, 2002

APPENDIX F

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

In re: DAOU SYSTEMS, INC., SECURITIES LITIGATION, GREG SPARLING; et al., Plaintiffs-Appellants, v. GEORGES DAOU; et al., Defendants-Appellees.	No. 02-56989 D.C. No. CV-98-01537-L/CGA Southern District of California, San Diego
In re: DAOU SYSTEMS, INC., SECURITIES LITIGATION, GREG SPARLING; et al., Plaintiffs-Appellees, v. GEORGES DAOU; et al., Defendants, and DAOU SYSTEMS, INC., Defendant-Appellant.	No. 02-57018 D.C. No. CV-98-01537-L/CGA Southern District of California, San Diego ORDER (Filed Jul. 14, 2005)

Before: B. FLETCHER, PREGERSON, and BRUNETTI, Circuit Judges.

The motion to recall the mandate is granted. Daou's petition for rehearing en banc is hereby filed.

APPENDIX G

NOT FOR PUBLICATION

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

In re: DAOU SYSTEMS, INC., SECURITIES LITIGATION, GREG SPARLING; EUGENE KRABBENHOFT; PATRICK DE KRUYFF, Esq.; ROBERT ZARETSKY; ROD FORD; THOMAS V. HAGMAN; RICHARD W. WALSH; RICHARD TORIBIO; PAUL RABIN, Plaintiffs-Appellants, v. GEORGES DAOU; DANIEL DAOU; FRED MCGEE; ROBERT MCNEILL; JOHN MORAGNE; DAOU SYSTEMS, INC., Defendants-Appellees.	No. 02-56989 D.C. No. CV-98-01537-L/CGA Southern District of California, San Diego ORDER (Filed Aug. 12, 2005)

In re: DAOU SYSTEMS, INC., SECURITIES LITIGATION, GREG SPARLING; EUGENE KRABBENHOFT; PATRICK DE KRUYFF, Esq.; ROBERT ZARETSKY; ROD FORD; THOMAS V. HAGMAN; RICHARD W. WALSH; RICHARD TORIBIO; PAUL RABIN, Plaintiffs-Appellees, v. GEORGES DAOU; DANIEL DAOU; FRED MCGEE; ROBERT MCNEILL; JOHN MORAGNE, Defendants, and, DAOU SYSTEMS, INC., Defendant-Appellant.	No. 02-57018 D.C. No. CV-98-01537-L/CGA Southern District of California, San Diego

Before: B. FLETCHER, PREGERSON, and BRUNETTI, Circuit Judges.

The panel has voted to deny the petition for rehearing en banc.

The full court has been advised of the petition for rehearing en banc and no judge has requested a vote on whether to rehear the matter en banc. Fed. R. App. P. 35.

The petition for rehearing en banc is DENIED.

APPENDIX H - STATUTE INVOLVED

15 U.S.C. § 78u-4

* * *

(b) Requirements for securities fraud actions

(1) Misleading statements and omissions

In any private action arising under this chapter in which the plaintiff alleges that the defendant –

(A) made an untrue statement of a material fact; or

(B) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading; the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.

(2) Required state of mind

In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

(3) Motion to dismiss; stay of discovery

(A) Dismissal for failure to meet pleading requirements

In any private action arising under this chapter, the court shall, on the motion of any defendant, dismiss the complaint if the requirements of paragraphs (1) and (2) are not met.

* * *

(4) Loss causation

In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages.

(e) Limitation on damages

(1) In general

Except as provided in paragraph (2), in any private action arising under this chapter in which the plaintiff seeks to establish damages by reference to the market price of a security, the award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.

(2) Exception

In any private action arising under this chapter in which the plaintiff seeks to establish damages by reference

to the market price of a security, if the plaintiff sells or repurchases the subject security prior to the expiration of the 90-day period described in paragraph (1), the plaintiff's damages shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the security and the mean trading price of the security during the period beginning immediately after dissemination of information correcting the misstatement or omission and ending on the date on which the plaintiff sells or repurchases the security.

* * *

(B) Proportionate liability

(i) In general Except as provided in subparagraph (A), a covered person against whom a final judgment is entered in a private action shall be liable solely for the portion of the judgment that corresponds to the percentage of responsibility of that covered person, as determined under paragraph (3).

(ii) Recovery by and costs of covered person In any case in which a contractual relationship permits, a covered person that prevails in any private action may recover the attorney's fees and costs of that covered person in connection with the action.

APPENDIX I

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UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF CALIFORNIA

In re DAOU SYSTEMS, INC. SECURITIES LITIGATION	Master File No. 98cv1537-L(CGA)
	CLASS ACTION
This Document Relates To: ALL ACTIONS	THIRD AMENDED CLASS ACTION COMPLAINT FOR VIOLATION OF THE FEDERAL SECURITIES LAWS
	DEMAND FOR JURY TRIAL
	(Filed May 16, 2002)

SUMMARY OF THE ACTION

1. This action is brought on behalf of a class of purchasers of Daou Systems, Inc. ("Daou" or the "Company") common stock between February 13, 1997 and October 28, 1998, inclusive (the "Class Period"), seeking damages resulting from a fraudulent scheme and course of business by defendants, which harmed purchasers of Daou stock during the Class Period. Defendants are the Company,

its Chief Executive Officer and Chairman Georges Daou ("G. Daou"), President and Director Daniel Daou ("D. Daou"), Chief Financial Officer and Senior Vice President Fred McGee ("McGee"), Chief Operating Officer and Executive Vice President Robert McNeill ("McNeill") and Director John Moragne ("Moragne"). Over the course of 20 months, beginning with Daou's initial public offering, each of these defendants issued false and misleading statements about Daou's accounting practices, revenue, earnings and business condition that, collectively, artificially inflated Daou's stock price to all-time high prices above $34 per share. In rapid succession, defendants sold $30.5 million of their personal stock holdings, the defendants' friends and families dumped an additional $24.2 million in Daou stock and defendants used $137.7 million worth of artificially inflated Daou securities for a corporate acquisition spending spree, all of which occurred while defendants knew that the Company's financial and business results were being misrepresented to the investing public.

2. Before its collapse, Daou designed, implemented, supported and managed computer network systems primarily for hospitals, integrated healthcare delivery networks and other healthcare provider organizations. Throughout the Class Period, Daou held itself out as a rapidly expanding, technologically astute, computer system design and support company, focused on the rapidly, changing medical field. For seven consecutive quarters, defendants reported that Daou had "record" growing revenues and that the Company's earnings per share ("EPS") had and would exceed market expectations published by securities analysts. Daou's self-professed "spectacular" results and "strong revenue and earnings growth" were coupled with public statements about Daou's successful employee retention and training and the benefits of the Company's

"extremely strong pipeline position." These statements drove Daou's stock price up to an all-time high of $34.375 per share by September 1997. All of these statements, however, were false and misleading when made.

3. Between 1Q97 and 2Q98, defendants recognized and publicly reported at least $18.6 million in revenue, more than 22% of Daou's total reported revenue, in violation of Generally Accepted Accounting Principles ("GAAP") and Daou's own stated accounting policy. Under the percentage of completion ("POC") accounting methodology defendants purported to follow, revenue from Daou's long-term network system contracts could only be recognized based on the percentage of labor costs incurred to date compared to total estimated labor costs for the project. Under GAAP, defendants could not arbitrarily determine what percent of a project was complete, but were required to recognize revenue in line with a reasonable and defensible degree of accuracy based on a comprehensive review of each contract. In fact, defendants recognized millions of dollars in revenue before it was earned and without regard to actual labor costs incurred or total estimated labor costs.

4. The first-hand accounts of 28 former Daou employees and customers demonstrate that the publicly reported revenue for 4Q96-2Q98 was artificially inflated by defendants' violations of Daou's accounting policy and GAAP. On contracts from Centura Health (Colorado) to Mercy Health Services (Iowa), defendants G. Daou, D. Daou, McGee and McNeill would immediately book 20% of the total contract value as revenue upon contract signing, whether or not any labor had yet been expended in the performance of the contract. On a $5 million contract, for example, defendants were booking $1 million in revenue

immediately, even though both GAAP and Daou's stated policy required that the revenue not be booked until Daou had incurred 20% of the total estimated labor costs for the project. Indeed, in at least one case, Candler Health Systems (Georgia), Daou recognized revenue in the final days of 3Q97 on a contract that was not even signed and, in the end, would never be executed. Defendants systematically, without regard to labor costs incurred or estimated, recognized 40% of the revenue from Daou's contracts immediately after the equipment to be installed was ordered and 50%-60% of the revenue as soon as the equipment was configured and tested. While the vast majority of labor costs were incurred after the equipment was sent to the customer for on-site installation and testing, the majority of revenue under defendants' scheme was recognized before substantial labor costs were incurred. In 2Q97 alone, 30%-40% of the revenue from Daou's Centura Health contract was recognized after Field Services employees had done nothing more than unpack and plug-in computers destined for the project. To create the appearance of actual labor costs incurred, defendants directed several Field Services employees to show up at Daou's San Diego facilities on the last Saturday in June 1997, plug in the Centura Health computers and claim eight hours of work each. In return, the salaried employees were offered $100 each. Not surprisingly, the employees were later told to forget about the incident, *i.e.*, to "forget it ever happened."

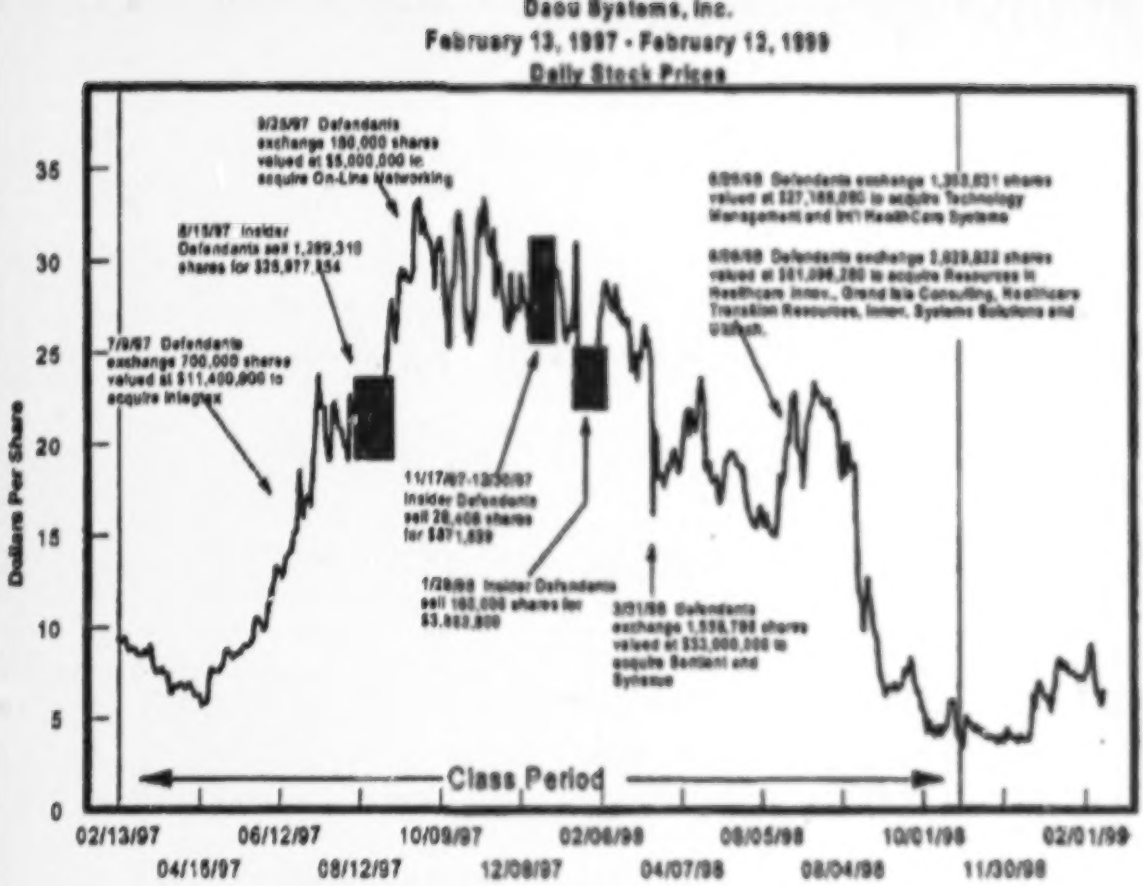
5. Even after equipment was actually shipped, defendants continued to recognize revenue in advance of what was allowed under Daou's accounting policy and GAAP. At the beginning of a project, Daou would "estimate" the labor hours needed to complete it on an *ad hoc*

basis, without considering the customer's facilities or equipment. The formula used to estimate labor hours became a joke among project engineers because it was grossly understated 99% of the time. The estimates of on-site project managers who knew exactly what work needed to be done and how long it would take were dramatically reduced by defendants without explanation. By underestimating the labor hours needed, the project would show a higher percentage of completion than if accurate figures were used. Daou would then record more revenue, even when it was unable to bill the customer for that amount. Defendants knew the labor estimates were incorrect because Daou kept track of actual labor hours worked versus hours estimated through employee job costing sheets compiled into the comprehensive Monthly Project Report. As a result of defendants' use of inaccurate and unreasonably low total estimated labor costs, defendants recognized revenue before it was earned, reporting revenue on contracts as if they were 100% completed, when, in fact, substantial work costing millions of dollars remained. On one occasion in early January 1998, an employee was specifically told she could no longer bill to a project because it was "closed" for billing purposes. But, the project was only slightly more than two-thirds completed. A larger proportion of the project had been billed and recorded as revenue in FY97 to increase earnings than was permitted in accordance with the true percent of labor completed.

6. Defendants' statements about Daou's employees and business pipeline were equally false and misleading. While investors and the market were told that Daou was successfully retaining employees and turnover was only 6.8%, turnover actually exceeded 40% and the engineers needed to implement the Company's network systems

were leaving Daou in droves. Defendants' representations regarding Daou's state-of-the-art training and the benefits of "Daou University" had no basis in fact. Daou had no formal training, was sending unqualified personnel, including auto mechanics and cable pullers who could not operate the most simple computer programs, into the field as PC technicians and senior engineers and Daou University did not exist and was instead a complete fiction. Daou's "pipeline" figures, publicly provided on a quarterly basis to demonstrate that Daou's business was continuing to expand, were equally fictitious. The "pipeline" was primarily composed of projected revenue on contracts for which Daou had merely made a bid or met with a customer, even when the odds of Daou getting the project were slim. Again, defendants' publicly disseminated financial information had no reasonable basis and were intended only to boost Daou's stock price.

7. All of these false and misleading statements had their desired effect, artificially inflating and maintaining the inflation in Daou's stock price. The following graph shows the price of Daou's stock during the Class Period and defendants' suspiciously-timed insider sales and corporate acquisitions using artificially inflated Daou stock. The second graph demonstrates that, when compared to an index of similar computer and data processing companies, the inflation and eventual collapse of Daou's share prices were due to Company-specific events and not to market forces:



Daou Systems
vs. Nasdaq Computer & Data Processing
February 1997 - January 2000

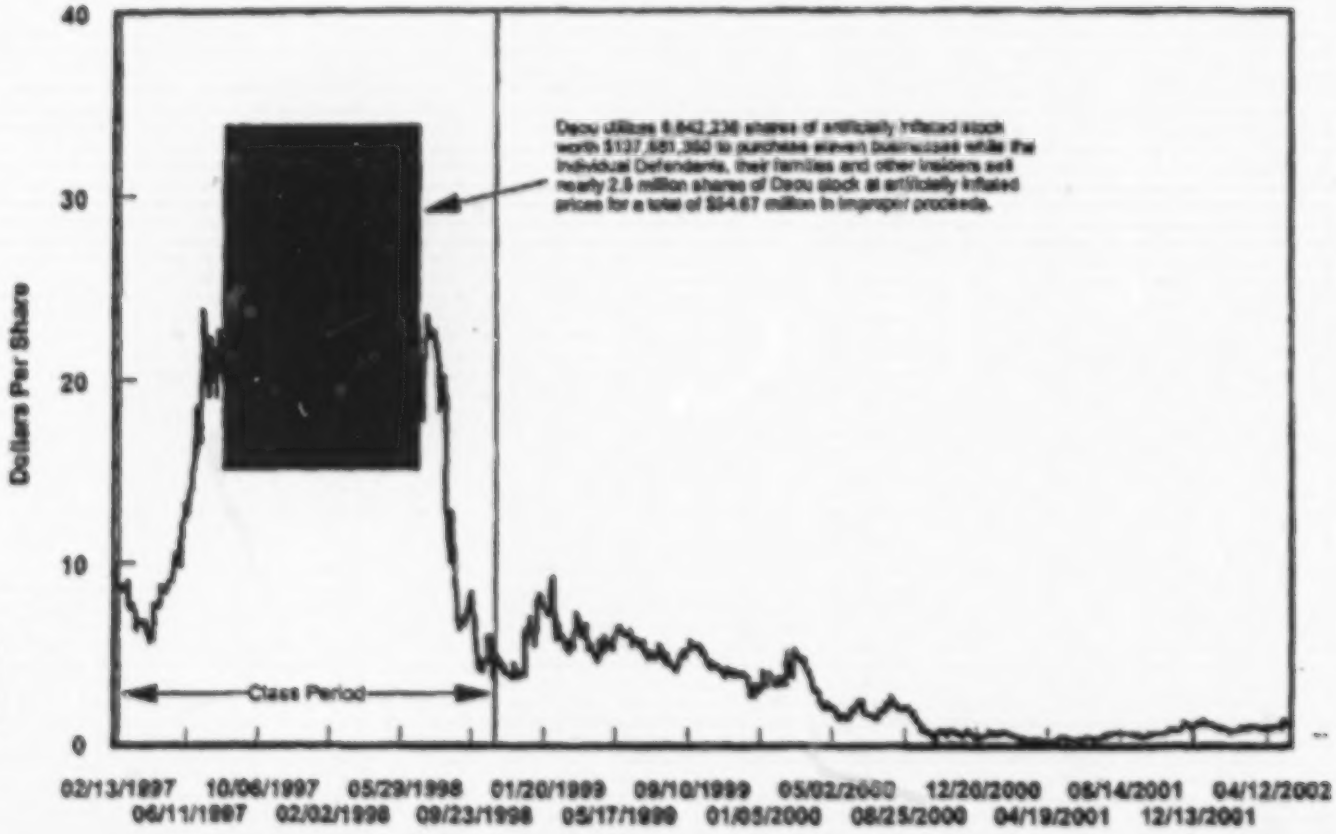
8. Due to defendants' deceptive and illegal conduct, lead plaintiffs and the other class members purchased their Daou shares at artificially inflated prices. Had lead plaintiffs and the other class members been aware of Daou's true financial results and condition, they would not have purchased their shares, or at least not at the artificially inflated prices at which they purchased those shares.

9. Finally, beginning in August 1998, defendants revealed that Daou's operating expenses and margins were deteriorating and, on October 28, 1998, defendants revealed that Daou had dramatically missed its projected 3Q98 earnings and would have to report a loss of $0.17 a share. Defendants further revealed that the Company's rapidly escalating work in progress account represented over $10 million in unbilled receivables – the direct result of prematurely recognizing revenue. These disclosures had a dramatic, negative effect on the market, causing Daou's stock to decline to $3.25 per share, a staggering 90% drop from the Class Period high of $34.375 and a $17 per share drop from early August 1998. Following these revelations, defendants conceded that Daou was moving its business practice away from fixed-price contracts with revenue recognized on a percentage of completion basis to charging on a time and expense basis. Nevertheless, Daou's stock price has never recovered and the Company has never been able to match the artificially inflated revenues reported during the Class Period.

Daou Systems, Inc.

February 13, 1997 - May 14, 2002

Daily Share Prices



JURISDICTION AND VENUE

10. Jurisdiction is conferred by 28 U.S.C. §§1331 and 1337; §22 of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. §77v; and §27 of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. §78aa.

11. The claims asserted herein arise under §§11, 12(a)(2) and 15 of the Securities Act and §§10(b) and 20(a) of the Exchange Act, 15 U.S.C. §§78j(b) and 78t(a), and Rule 10b-5 promulgated thereunder, 17 C.F.R. §240.10b-5.

12. Venue is proper in this District pursuant to §27 of the Exchange Act and 28 U.S.C. §1391(b). Daou had its headquarters and principal place of business in this District during the Class Period. The false and misleading statements were made or issued from this District, and most of the Individual Defendants live here. Thus, most of the acts and transactions giving rise to the [illegible] of law complained of occurred in this District.

13. In connection with the acts alleged in this complaint, defendants, directly or indirectly, used the means and instrumentalities of interstate commerce, including, but not limited to, the mails, interstate telephone communications and the facilities of the national securities markets.

THE PARTIES

14. Greg Sparling, Eugene Krabbenhoft, Patrick de Kruyff, Robert Zaretsky, Rod Ford, Thomas V. Hagman, Richard W. Walsh, Richard Toribio and Paul Rabin (collectively "plaintiffs" or "lead plaintiffs,") who were appointed as lead plaintiffs pursuant to the Court's Order, dated December 14, 1998, each purchased or acquired publicly

traded securities of Daou at artificially inflated prices during the Class Period, and was damaged thereby. The lead plaintiffs purchased a total of 66,795 shares of Daou during the Class Period and suffered damages exceeding $230,000. Appendix A hereto identifies each of the separate purchase transactions of the lead plaintiffs.

15. Defendant Daou is incorporated in Delaware and maintained its principal executive offices during the Class Period at 5120 Shoreham Place, San Diego, California 92122. Following the Class Period, Daou closed its San Diego headquarters and what is left of the company is based in Exton, Pennsylvania. At all relevant times herein, Daou was listed as a publicly held corporation whose shares were traded in an efficient market on the NASDAQ National Market System ("NASDAQ").

16. (a) Defendant Georges J. Daou ("G. Daou") was at all relevant times Chief Executive Officer and Chairman of the Board of the Company. During the Class Period, defendant G. Daou sold or disposed of at least 554,937 shares of his Daou stock for proceeds of $11,241,249.

(b) Defendant Daniel J. Daou ("D. Daou") was at all relevant times President and a Director of the Company. During the Class Period, defendant D. Daou sold or disposed of at least 554,937 shares of his Daou stock for proceeds of $11,241,249.

(c) Defendant Fred C. McGee ("McGee") was at all relevant times Senior Vice President, Chief Financial Officer and Secretary of the Company. During the Class Period, defendant McGee sold or disposed of at least 22,600 shares of his Daou stock for proceeds of $504,700.

McGee exercised options to purchase 12,600 of the shares he sold for $4.28 per share.

(d) Defendant Robert J. McNeill ("McNeill") was at all relevant times Executive Vice President and Chief Operating Officer of the Company. During the Class Period, defendant McNeill sold or disposed of at least 17,000 shares of his Daou stock for proceeds of $510,120. McNeill exercised options to purchase 11,060 of the shares he sold for $4.28 per share.

(e) Defendant John H. Moragne ("Moragne") was at all relevant times a director of the Company. During the Class Period, defendant Moragne sold or disposed of at least 328,244 shares of his or his related entities' Daou stock for proceeds of $7,015,075.

17. The individuals named as defendants in ¶16(a)-(e) are referred to herein as the "Individual Defendants." The Individual Defendants, because of their substantial ownership of and positions with Daou, possessed the power and authority to control the contents of the Company's quarterly reports, press releases and presentations to securities analysts, money and portfolio managers and institutional investors, *i.e.*, the market. Statements of confidential witnesses identified in this Complaint reflect the Individual Defendants' actual knowledge of improper revenue recognition, improper accounting practices, significant employee problems and lack of reliable pipeline information throughout the Class Period. The Individual Defendants had direct conversations with witnesses on these topics, discussed them in group meetings and had access to internal corporate documents (including weekly and monthly project reports, pipeline reports and forecasts and reports of actual operations compared thereto).

Because of their access to material nonpublic information and their personal direction of Daou's revenue recognition and financial reporting, the Individual Defendants each knew that the adverse facts specified herein had not been disclosed to and were being concealed from the public and that the financial reports and positive representatives which were being made were materially false and misleading. The Individual Defendants are liable for the false statements pleaded herein at ¶¶24, 44, 47, 50, 53, 57, 60, 64, 67, 71 and 75, as those statements were each "group-published" information, they were the result of the collective action of the Individual Defendants.

18. Each of the Individual Defendants except Moragne, because of their positions with the Company, controlled and/or possessed the power and authority to control the contents of its quarterly and annual reports, press releases and presentations to securities analysts, through whom information was conveyed to the investing public. In addition, Daou controlled each of the Individual Defendants. These defendants are thus liable under §20(a) of the Exchange Act and §15 of the Securities Act.

19. None of the Individual Defendants is still an officer at Daou.

CONFIDENTIAL SOURCES

20. The allegations of falsity and actual knowledge pled herein are made on information and belief and are supported by the first-hand accounts of 28 confidential witnesses, including former Daou employees, consultants and customers. Confidential witnesses have been identified with as much particularity as possible without disclosing their identity. Plaintiffs are informed and believe that

disclosing the witnesses' identities publicly, and/or to defendants, could result in serious injury to the witnesses or their careers. The confidential witnesses are as follows:

(a) Confidential Witness #1 ("CW1") is a former Daou Project Cost Analyst. CW1 was responsible for obtaining project information, such as percentage of completion estimates from the project managers, and analyzing individual project budgets. CW1's duties included entering the percentage of completion information into Daou's accounting system (the ManFact accounting system) after receipt from the project managers, generating project reports from ManFact, and delivering those reports to Daou's Vice Presidents Ron Mirabile ("Mirabile") and Eric S. Ringwall ("Ringwall"). Daou's Vice Presidents would "adjust" the reported percentage of completion estimates and return the adjusted reports to CW1. CW1 was responsible for entering those adjusted numbers into ManFact. CW1, along with other Daou Project Cost Analysts, was in direct communication with Daou's Project Managers regarding percentage of completion discrepancies and project budget issues.

(b) Confidential Witness #2 ("CW2") is a former employee in Daou's Technical Training Department. CW2 maintained a training file on each Daou employee enrolled in the technical training program called Daou Training Standards ("DTS").

(c) Confidential Witness #3 ("CW3") is a former Daou Senior Design Engineer. CW3 was responsible for gathering data on Daou's projects (*i.e.*, surveying customers' needs and then developing a proposal that included network options and pricing), designing proposed networks and assisting Daou's systems engineers during

installation. CW3 worked closely with Daou's sales staff who would take the information gathered by CW3 and present it to the client at what was known as a "technology conference." CW3 was familiar with Daou's cost estimation program which was imbedded in an Excel spreadsheet format and linked to Daou's proposal software program.

(d) Confidential Witness #4 ("CW4") is a former Daou Staff Accountant. CW4 was responsible for keeping Daou's general ledger, which included verifying that all project accounting entries were made to the proper accounts in the ManFact accounting system. Because of his position as Staff Accountant, CW4 was familiar with Daou's project accounting process.

(e) Confidential Witness #5 ("CW5") is a former Daou Executive Assistant. CW5 worked for an executive in Daou's Field Services department and was responsible for managing engineers and interfacing with customers concerning project engineering issues.

(f) Confidential Witness #6 ("CW6") is a former Daou executive who worked in the Finance Department. CW6 dealt with audit issues, Securities and Exchange Commission ("SEC") reporting and budget matters. As such, CW6 was familiar with Daou's process of collecting project cost information. CW6 reported to defendant McGee.

(g) Confidential Witness #7 ("CW7") is a former Financial Consultant to defendant Fred McGee and was responsible for addressing various audit and SEC reporting issues. CW7 was familiar with Daou's process for collecting project cost information. In addition, CW7 had knowledge about Daou's cost accounting procedures,

percentage of completion accounting and revenue recognition determination. CW7 has first hand knowledge of conversations among the finance and accounting staff concerning the validity of Daou's accounts receivable.

(h) Confidential Witness #8 ("CW8") is a former Daou Field Services Engineer. CW8 was responsible for implementing and managing system network projects and conducting analyses of potential clients' networking infrastructures. CWS dealt directly with the customer's Chief Information Officer and Senior IT or IS staff as well as Daou account managers and implementation managers, as well as Field Services Vice President Mirabile.

(i) Confidential Witness #9 ("CW9") is a former Daou Regional Vice President of Sales. As Vice President of Sales, CW9 was responsible for reporting weekly or biweekly sales information, such as sales status/backlog and forecast/pipeline information, to Daou's Vice Presidents and corporate officers.

(j) Confidential Witness #10 ("CW10") is a former Daou Sales Account Manager.

(k) Confidential Witness #11 ("CW11") is a former Administrative Assistant to the Chief Information Officer at Candler Hospital ("Candler"), a customer of Daou. CW11 has personal information about the contract between Daou and Candler.

(l) Confidential Witness #12 ("CW12") is a former Daou Senior Network Engineer. CW12 was responsible for all aspects of implementing a network system. CW12 was responsible for reporting percentage of completion estimates to Daou's Vice Presidents.

(m) Confidential Witness #13 ("CW13") is a former Daou Accounting Department Manager. As the Accounting Manager, CW13 controlled the general ledger, accounts payable, payroll and accounts receivable.

(n) Confidential Witness #14 ("CWI4") was a securities analyst who covered Daou. CW14 conducted research regarding Daou's earnings and participated in conference calls and meetings with Daou's executives. CW14 issued reports regarding Daou's performance to the investing public.

(o) Confidential Witness #15 ("CW15") is a former Daou Design and Implementation Engineer. CW15 was responsible for estimating the percentage of completion for certain projects and for submitting the estimates to Daou's accounting department.

(p) Confidential Witness #16 ("CW16") is a former Daou Financial Analyst. CW16 is familiar with the procedure by which Daou received employee time entries for each project from the field. CW16 has knowledge about the monthly reports generated from ManFact and the monthly pipeline reports. CW16 is also knowledgeable about who at Daou received these monthly reports.

(q) Confidential Witness #17 ("CW17") is a former Daou Financial Analyst. CW17 was responsible for job costing. CW17 is familiar with the procedure by which Daou received employee time entries for each project from the field. CW17 has knowledge about the monthly reports generated from ManFact (such as the Monthly Project Report) and the Monthly Pipeline Report. CW17 has personal knowledge about who at Daou received these monthly reports.

(r) Confidential Witness #18 ("CW18") is a former Daou *Financial* Consultant. CW18 has knowledge about Daou's weekly forecast reports which compared actual results to budgeted results.

(s) Confidential Witness #19 ("CW19") is a former officer at Mercy Health Services Corp. CW19 is knowledgeable about the quality and availability of service provided by Daous on-site technicians. CW19 is also knowledgeable about the fact that Daou was not retaining employees such as technicians and account managers. In addition, CW19 has communicated directly with defendant G. Daou concerning bids on certain projects and problems that arose thereafter.

(t) Confidential Witness #20 ("CW20") is a former Daou Field Services Engineer. CW20 worked on-site at several Daou customer locations.

(u) Confidential Witness #21 ("CW21") is a former Daou Field Services Technician. CW21 is familiar with the quality of technical work performed by Daou technicians. CW21 is knowledgeable about Daou's "burn-in" practice.

(v) Confidential Witness #22 ("CW22") is a former Daou Sales Account executive. CW22 was responsible for developing and contracting new business.

(w) Confidential Witness #23 ("CW23") is a former Executive Assistant. CW23 attended Daou's Board of Director meetings and had frequent contact with various Daou executives.

(x) Confidential Witness #24 ("CW24") is a former Daou Project Manager. CW24 has firsthand knowledge regarding Daou's contracts with the University of Chicago.

(y) Confidential Witness #25 ("CW25") is a former Daou division Director. CW25 was responsible for contract outsource management personnel.

(z) Confidential Witness #26 ("CW26") is a former Daou Field Services Engineer. CW26 worked onsite at several Daou customer locations.

(aa) Confidential Witness #27 ("CW27") is a former Manager in Daou's Accounting Department.

(bb) Confidential Witness #28 ("CW28") is a former Daou Sr. Network Engineer and Project Manager. CW28 had regular personal communication with Daou's Vice Presidents and was responsible for reporting percentage of completion estimates to them.

DAOU'S FALSE FINANCIAL REPORTING DURING THE CLASS PERIOD

Percentage of Completion Accounting

21. In accounting for income from long-term construction type contracts, one method permitted under GAAP is the percentage of completion ("POC") method. POC accounting is intended to recognize income as work progresses based on either the percentage of costs incurred divided by total estimated costs or the percentage of labor incurred divided by total estimated labor hours. *See* Accounting Research Bulletin ("ARB") No. 45, ¶4. An

essential co[illegible]nent of POC accounting is the ability to maintain a c[illegible]nsible and reasonable degree of accuracy in identifying both total labor costs and labor costs incurred. Recognition of revenue under POC accounting is not simply a matter of business judgment, but must be based on a comprehensive review of each individual contract, the actual costs or labor incurred and a "realistic estimate of costs [for labor] to complete all phases of the contract." *See* AICPA Manual at §8.10. Moreover, the mere purchase of generic raw materials, such as computer equipment, does not qualify as a labor cost incurred. *See* AICPA Statement of Position ("SOP") No. 81-1.50, According to GAAP, as set forth in AICPA SOP No. 81-1, percentage of completion income recognition is a specific methodology intended to present the accurate economic substance of a company's transactions. See SOP 81-1.22.

22. GAAP are those principles recognized by the accounting profession as the conventions, rules and procedures necessary to define accepted accounting practices at a particular time. SEC Regulation S-X (17 C.F.R. §210.4-01(a)(1)) states that financial statements filed with the SEC which are not prepared in compliance with GAAP are presumed to be misleading and inaccurate, despite footnote or other disclosure. Reg S-X requires that interim financial statements must also comply with GAAP, with the exception that interim financial statements need not include disclosures that would be duplicative of disclosures accompanying annual financial statements. 17 C.F.R. §210.10-01(a).

23. The Securities and Exchange Commission ("SEC") has noted that "Percentage of Completion accounting requires that there be an *accurate* method to measure what portion of a job has been completed." SEC Accounting

and Auditing Enforcement Release ("AAER") No. 356 (March 2, 1992). The SEC has also brought enforcement actions for failure to properly recognize revenue under the percentage of completion method where a company's senior management recognized revenue in excess of the percentage of work performed as reported by the company's project manager. *See* AAER No. 274 (Sept. 26, 1990).

Defendants' Manipulation of Percentage of Completion Accounting

24. Defendants represented to shareholders and the market that Daou complied with GAAP and the Company's own POC accounting policy. Daou's 1997 Form 10-K represented that:

> REVENUE RECOGNITION
>
> ***Contract revenue for the development and implementation of network solutions is recognized on the percentage-of-completion method with progress to completion measured by labor costs incurred to date compared to total estimated labor costs.*** Provisions for estimated losses on contracts, if any, are made during the period when the loss becomes probable and can be reasonably estimated. Revenues recognized in excess of amounts billed and project costs are classified as contract work in progress. Revenue from technical support and network management services is recognized over the period the services are performed. Payments received in advance of services performed are recorded as deferred revenue and amortized as the services are performed.

25. In truth, during the Class Period, defendants did not comply with GAAP or Daou's stated manner of recognizing revenue under POC accounting. Daou reported the following quarterly amounts during the Class Period (prior to the restatement of Daou's results pursuant to its acquisitions):

	3/31/97	6/30/97	9/30/97	12/31/97	3/31/98	6/30/98
Revenue	$5.2 M	$6.0 M	$11.3 M	$14.5 M	$ 18.1 M	$28.0
Net Income	($.2 M)	$ .05 M	$ .6 M*	$ .7 M	$ 1.4 M*	$2.2M*
EPS	($0.02)	$0.01	$ 0.05*	$ 0.06	$ 0.10*	$0.12*

*Excluding merger charges.

26. The above results were reported in press releases issued by Daou. Daou also included its interim results in reports on Form 10-Q filed with the SEC.[1] With regard to the financial information included in the Form 10-Q's, Daou represented that "in the opinion of management," its financial statements "fairly present[ed]" the Company's results and financial position. The December 31, 1997 results were incorporated in Daou's annual 1997 financial statements filed with the SEC in a report on Form 10-K. Daou also included its fourth quarter and year end December 31, 1996 results in its February 13, 1997 Initial Public Offering ("IPO") Prospectus and Registration Statement as follows:

	Qtr 12/31/96	Year 12/31/96
Revenue	$7.0M	$19.3M
Net Income	$ .066M	($ .402M)
EPS	(Pro Forma)	$ .01

27. As detailed herein, defendants caused Daou to falsify its reported financial results through the recognition of revenue in advance of earning such revenue or being entitled to record the revenue. Specifically, defendants did not record revenue based on the percentage of actual labor costs incurred compared to labor costs estimated. First, defendants recognized up to 50% or more of the total value of new contracts when little or no actual labor costs had been incurred and without regard to the actual percentage of completion. Second, defendants

[1] When Daou subsequently issued its Form 10-Q for the quarter ended 6/30/98, it had reclassified merger charges from the figures it reported in the July 29, 1998 call with analysts, and earnings before charges were reduced to approximately $800,000.

inflated the percentage of actual labor costs incurred to total estimated labor costs that were submitted by Daou's project managers. Third, defendants grossly underestimated projections of total labor costs needed to complete contracts that had no reasonable basis and were disputed by Daou's on-site manager. Each of these schemes violated both GAAP and Daou's stated accounting policy and served to prematurely inflate Daou's reported revenue by millions of dollars.

28. Confidential witnesses from Daou's Field Services and Accounting departments individually and collectively described defendants' recognition of revenue before labor costs were incurred. Immediately upon signing installation and implementation contracts, defendants would record 20% of the total contract value as revenue, prior to work being performed or any labor costs being incurred. Upon ordering the equipment for a project, which occurred on at least one occasion before the project contract was signed, defendants would record 40% of the total contract value as revenue. Confidential witnesses further confirm that 50%-60% of the total contract value would be recognized as revenue as soon as the contract equipment was configured and tested in Daou's facilities. Accordingly, Company sources confirm that 50% or more of the revenue from Daou's contracts was recognized when little or no labor costs had been incurred. The installation and implementation projects were labor-intensive and the majority of labor costs were incurred ***after*** any equipment was shipped to the project location. Recognizing revenue based on a contract signing or equipment orders, with no relation to the labor costs incurred or percent of the project completed, violated both GAAP and Daou's accounting

policy, revenue, as described above, was only to be recognized as work actually progressed on the contract. *See* ARB No. 43, ¶4.

29. For projects with ongoing labor costs, defendants inflated the percentage of labor costs incurred. Field Services Project Managers tracked billable hours and projected hours on Daou's job costing sheet. On a monthly basis, these figures were compiled into a single Monthly Project Report covering all of Daou's then existing contracts. According to confidential witnesses, following the defendants' month and quarter end review of the Project Report, Field Services executives would tell the project managers to alter their projected hour calculations or would manually change the project manager's reports in the Company's ManFact accounting system. In doing so, defendants were able to recognize revenue on contracts prematurely, thereby violating GAAP requirements that the revenue recognized have a reasonable basis because defendants did not use the labor cost incurred and estimated labor cost figures provided by the actual project managers.

30. Defendants also manipulated Daou's reported revenue by failing to use accurate or reasonable estimates of the estimated labor costs necessary to complete contractual terms. Again, according to confidential witnesses, defendants failed to apply accurate estimates of total labor costs necessary as supplied by the Company's project managers and engineers. Defendants utilized materially lower project estimates in order to more quickly recognize revenue. As a result, the percentage of revenue recognized exceeded the percentage of the project actually completed or labor costs necessary, a violation of GAAP and Daou's stated accounting policy.

31. Specific instances of each of the above practices are identified herein at ¶¶44, 47, 50, 53, 57, 60, 64, 67, 71 and 75.

Impact of Defendants' Accounting Fraud

32. Defendants violated GAAP and Daou's stated accounting policy in order to inflate its revenues and earnings by immediately recognizing revenue on contracts before labor costs were incurred and arbitrarily altering its percentage completion estimated to result in higher revenues. As a result, Daou reported revenue well before it was entitled to pursuant to GAAP. This resulted in Daou accumulating large amounts of accounts receivable it could not collect, including millions in receivables it was not entitled to bill to its customers. Note the following:

- The contract work in progress account on Daou's balance sheet, which included amounts Daou had recognized as revenue but for which it was not entitled to bill its customers and amounts of implementation costs it had incurred but had not yet recognized as an expense against earnings, grew from less than $400,000 in 1995 to more than $22 million in Q2 1998.

- Even though reported net income was increasing, Daou was experiencing a marked increase in its quarterly cash flow ***deficit*** from operations (in thousands)

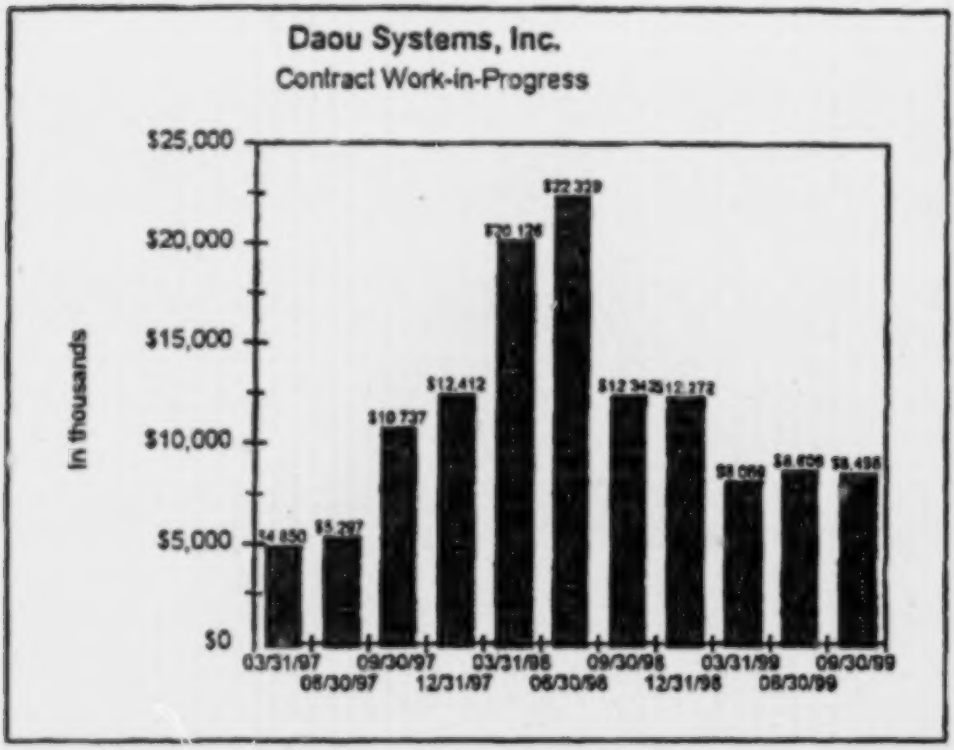
Q1 97	Q2 97	Q3 97	Q4 97	Q1 98
$455	$1,605	$3,123	$6,957	$7,184

- Accounts receivable grew from only $3.4 million at 3/31/97 to nearly $20 million at 6/30/98.

- Gross margins were also inflated by Daou's improper revenue recognition, increasing to 40% in Q1 1998. Following the end of the Class Period, gross margin dropped precipitously, to a mere 15% in Q4 1998. This results from Daou now completing work which it had previously reported as revenue.

- Days sales outstanding (a measure of the estimated time to collect receivables) for receivables and contract work in progress was 182 days at 3/31/98 and was 136 days by 6/30/98.

- The contract work in progress account continually became a much more significant part of Daou's financial statements as Daou continued to recognize additional revenue and post more unbilled receivables to this account. Following the end of the Class Period, contract work in progress in both dollar amount and as a percentage of total assets returned to lower levels. Note the following charts:


Daou Systems, Inc.
Contract Work-in-Progress
In thousands
$25,000
$20,000
$15,000
$10,000
$5,000
$0
$4,850
$5,297
$10,737
$12,412
$20,126
$22,339
$12,345
$12,272
$8,059
$8,496
$8,498
03/31/97
06/30/97
09/30/97
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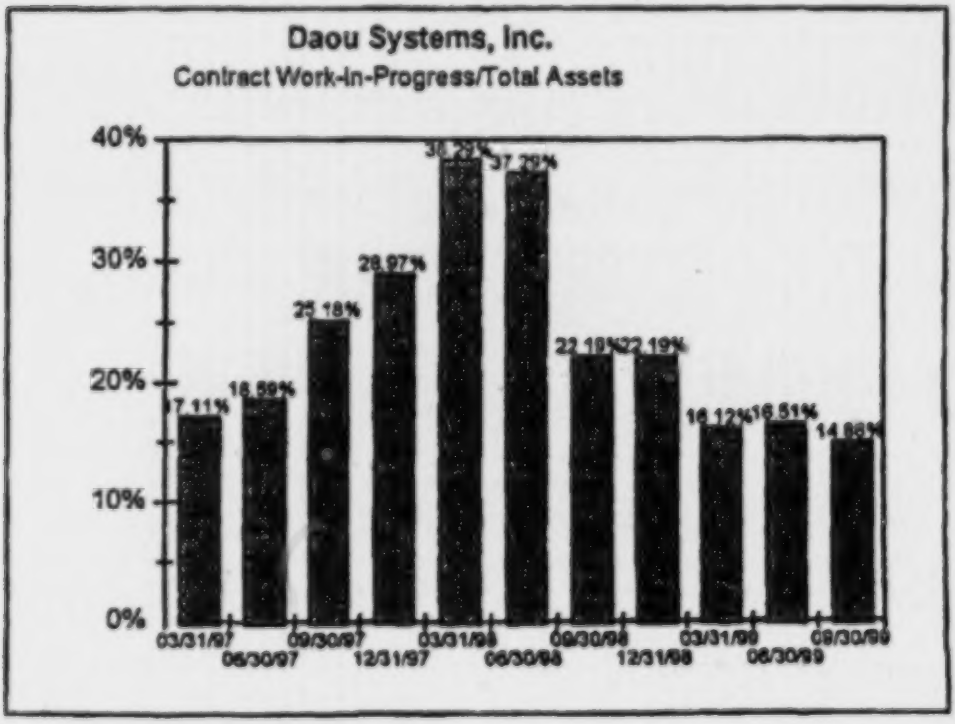
06/30/98
09/30/98
12/31/98
03/31/99
06/30/99
09/30/99


Daou Systems, Inc.
Contract Work-in-Progress/Total Assets
40%
30%
20%
10%
0%
17.11%
16.88%
25.18%
28.97%
38.29%
37.29%
22.19%
22.19%
16.12%
16.51%
14.88%
03/31/97
06/30/97
09/30/97
12/31/97
03/31/98
06/30/98
09/30/98
12/31/98
03/31/99
06/30/99
09/30/99

34. Due to these accounting improprieties, the Company presented its financial results and statements in a manner which violated GAAP, including the following fundamental accounting principles:

(a) The principle that financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit and similar decisions was violated (FASB Statement of Concepts No. 1, ¶34);

(b) The principle that financial reporting should provide information about the economic resources of an enterprise, the claims to those resources, and effects of transactions, events and circumstances that change resources and claims to those resources was violated (FASB Statement of Concepts No. 1, ¶40);

(c) The principle that interim financial reporting should be based upon the same accounting principles and practices used to prepare annual financial statements (APB No. 28, ¶12);

(d) The principle that financial reporting should provide information about how management of an enterprise has discharged its stewardship responsibility to owners (stockholders) for the use of enterprise resources entrusted to it was violated. To the extent that management offers securities of the enterprise to the public, it voluntarily accepts wider responsibilities for accountability to prospective investors and to the public in general (FASB Statement of Concepts No. 1, ¶50);

(e) The principle that financial reporting should provide information about an enterprise's financial performance during a period was violated. Investors and

creditors often use information about the past to help in assessing the prospects of an enterprise. Thus, although investment and credit decisions reflect investors' expectations about future enterprise performance, those expectations are commonly based at least partly on evaluations of past enterprise performance (FASB Statement of Concepts No. 1, ¶42);

(f) The principle that financial reporting should be reliable in that it represents what it purports to represent was violated. That information should be reliable as well as relevant is a notion that is central to accounting (FASB Statement of Concepts No. 2, ¶¶58-59);

(g) The principle of completeness, which means that nothing is left out of the information that may be necessary to insure that it validly represents underlying events and conditions was violated (FASB Statement of Concepts No. 2, ¶79); and

(h) The principle that conservatism be used as a prudent reaction to uncertainty to try to ensure that uncertainties and risks inherent in business situations are adequately considered was violated. The best way to avoid injury to investors is to try to ensure that what is reported represents what it purports to represent (FASB Statement of Concepts No. 2, ¶¶95, 97).

35. Further, the undisclosed adverse information concealed by defendants during the Class Period is the type of information which, because of SEC regulations, regulations of the national stock exchanges and customary business practice, is expected by investors and securities analysts to be disclosed and is known by corporate officials and their legal and financial advisors to be the type of information which is expected to be and must be disclosed.

DEFENDANTS' INSIDER TRADING AND USE OF ARTIFICIALLY INFLATED STOCK FOR ACQUISITIONS

36. Defendants' insider trading and use of Daou's artificially inflated stock to make corporate acquisitions support a strong inference of scienter. While defendants were issuing the false statements identified herein about Daou's financial results and business, the Individual Defendants sold at least 1,477,718 shares of Daou stock – only days after issuing favorable statements about the Company – for proceeds exceeding $30.5 million, thereby personally profiting from the artificial inflation in Daou's stock price which their fraudulent scheme had created. Notwithstanding their knowledge about Daou's improperly recognized revenue and their duty as officers and directors of Daou to disclose adverse material facts before trading in Daou stock, the Individual Defendants sold enormous amounts of Daou shares at artificially inflated prices in order to profit from the fraud. Defendants' insider selling during the Class Period is detailed below:

Defendant	Date Sold	Shares Sold/ Disposed Of	Price Per Share	Value
Georges J. Daou	08/15/97	479,937	$19.85	$ 9,526,749
	01/29/98	75,000	$22.86	$ 1,714,500
		554,937		$11,241,249
Daniel J. Daou	08/15/97	479,937	$19.85	$ 9,562,749
	01/29/98	75,000	$22.86	$ 1,714,500
		554,937		$11,241,249
Fred C. McGee	08/15/97	12,600	$21.50	$ 270,900
	01/29/98	10,000	$23.38	$ 233,800
		22,600		$ 504,700

Robert J. McNeill	12/22/97	2,000	$30.06	$ 60,120
	12/29/97	9,000	$30.00	$ 270,000
	12/30/97	6,000	$30.00	$ 180,000
		17,000		$ 510,120
John H. Moragne	08/15/97	308,233	$21.00	$ 6,472,893
	08/15/97	8,603	$21.00	$ 180,663
	11/17/97	11,408	$31.69	$ 361,519
		328,244		$ 7,015,075
TOTALS:		1,477,718		$30,512,393

37. The percentage of each defendants' massive insider selling during the Class Period is summarized below:

33. In fact, had Daou reported its revenues in line with the amounts it was entitled to bill customers pursuant to its contracts, it would have reported materially lower revenue in each quarter during the Class Period:

	1Q97	2Q97	3Q97	4Q97	1Q98	2Q98
Reported Revenues	$5.2 M	$6.0 M	$11.3 M	$14.5 M	$18.1 M	$28.0 M
Revenues as per billing	$4.1 M	$5.6 M	$5.9 M	$12.8 M	$10.3 M	$25.8 M

Daou's 1996 revenues, reported to be $19.3 million, also would have been materially lower – at only $16.0 million. The difference between Daou's publicly reported revenue and the revenue that should have been recognized and reported under GAAP is material:

Reported Revenues 1Q97-2Q98	Revenues as per Billing 1Q97-2Q98	Material Difference	% of Revenue Overstatement
$83.1 M	$64.5 M	$18.6 M	28.8%

Defendant	Shares Beneficially Owned @ 2/12/97 (1)	Total Holdings with Options (1)	Sales	% of Holdings Sold	Class Period Sales as a % of Total Sales from 2/13/97-12/31/00
G. Daou	1,957,361	1,957,361	554,937	28.35%	100%
D. Daou	1,952,361	1,952,361	554,937	28.42%	100%
F. McGee	0	28,060	22,600	80.54%	50% (2)
R. McNeill	0	25,254	17,000	67.32%	100%
J. Moragne	737,083	751,099	328,244	43.70%	100%

(1) Form 3 Initial Statement of Ownership filed with the SC.
(2) F. McGee sold 22,600 shares on 9/14/99.

38. These sales were not merely unusual in amount, but also were made at suspicious times. No defendant was engaged in a fixed pattern of sales. No defendant other than McGee has ever sold Daou shares except those sold during the Class Period. Further, the fact that 98% of all insider sales, totaling $29.6 million, took place on only two trading days (August 15, 1997 and January 29, 1998) is highly suspect and indicative of coordinated selling among defendants. The Individual Defendants also timed their sales to take advantage of the huge increase in the price of Daou stock that immediately followed their false statements and reports and recommendations of securities analysts who based their favorable investment ratings on information provided by defendants concerning Daou's financial results. The January 29, 1998 insider sales occurred only one week after defendants reported Daou's "record" 4Q and FY97 results. The August 15, 1997 sales, made within one month of Daou's all-time high stock price, were coordinated concurrently with false representations in its Prospectus and Registration Statements about the Company's adherence to its accounting policy and "record" 1Q and 2Q97 results. The named defendants were not the only insiders to profit from the fraud. Daou insiders, including Senior Vice President Dan L. Porter – who sold 100% of his holdings between November 19, 1997 and December 30, 1997 – Jonathan Kendall and J. Kirby Farrell, dumped at least 351,029 of their shares, all at the same time defendants were unloading their Daou stock, at artificially inflated prices for proceeds of $6,098,976. And, the families of defendants G. Daou and D. Daou, including Joseph Daou (father and former Treasurer of Daou), Katherine Daou, Anne Daou and Elizabeth Daou, dumped at least 651,216 shares of the Company's stock during the

Class Period based on adverse, non-public information for proceeds of $18,061,277. All told, defendants, their families and Daou insiders sold nearly 2.5 million shares of Daou stock at artificially inflated prices for a total of $54.67 million in improper proceeds.

39. Each of the Individual Defendants also had motive to inflate Daou's stock price and perpetrate the fraudulent scheme and course of business complained of to complete corporate acquisitions. During the Class Period, Daou was actively engaged in reviewing several potential acquisitions to grow its business and customer base. However, as of June 30, 1997, Daou had only $14.5 million in cash and was experiencing net losses for the second straight quarter since the Company's IPO. Because Daou needed to conserve its cash to fund ongoing operations, it had to use stock for acquisitions. Using Daou stock to pay for acquisitions, however, meant that it was of critical importance for Daou to report profitable growth and a strong financial condition to keep its stock price at high levels so that Daou stock would appear attractive to the businesses Daou was attempting to acquire. This put tremendous pressure on Daou's executives to present its business and finances in a very favorable light. Defendants succumbed to this pressure when they improperly recognized revenue through their abuse of the POC method and recognized revenue in advance of earning it, or being entitled to record it, in violation of GAAP. Defendants were successful as Daou acquired 11 companies during the Class Period by exchanging over 6.6 million shares of Daou stock valued at almost $140 million. The following is a list of the companies acquired and the number of shares Daou "saved" by inflating the price of the Company's stock:

40. According to Daou's 2Q97 10-Q, Daou had 50,000,000 shares of common stock authorized, and of that number, 10,267,678 was issued and outstanding as of June 30, 1997. Therefore, if defendants had not artificially inflated the price of Daou's stock, they would have had to issue an additional 19.6 million shares (a total of 26.3 million shares) to complete the acquisitions. With only 40,000,000 shares available to issue and a low cash balance, the ability to issue more shares necessary to support Daou's aggressive acquisition spree would have been difficult, if not impossible. Recognizing this, defendants added the following language into the August 15, 1997 Prospectus: "Future sales of substantial amounts of Common Stock in the public market could adversely affect market prices prevailing from time to time and the ability of the Company to raise equity capital in the future."

41. The Individual Defendants' desire to sell their own and/or Daou's stock on the February 13, 1997 IPO and the August 15, 1997 Secondary Offering also provided them with a motive to inflate Daou's stock price. If Daou's share price remained at an inflated level as a result of defendants' false statements and improper accounting, the defendants could take advantage of the inflated price for their own financial enrichment, before the undisclosed adverse information known to defendants became public and Daou's stock price collapsed. The IPO of two million shares at $9.00 per share raised Daou a net of $15.8 million. The August 19, 1997 Secondary Offering of 2,365,000 shares of the Company's common stock further enabled Daou to raise a net $9.3 million in badly needed cash and the Individual Defendants and insiders to unload nearly $26 million worth of their individual stock holdings

at artificially inflated prices before the truth about Daou's fraudulent accounting practices became public:

Defendants	Shares sold in 8/15/97 Offering	Proceeds From 8/15/97 Offering
Daou Systems, Inc.	500,000	$9,300,000
Daniel Daou	479,937	9,526,749
Georges Daou	479,937	9,526,749
John Moragne (including affiliates)	316,836	6,653,556
Fred McGee	12,600	270,900
TOTALS:	1,789,310	$35,277,954

Even after the August 15, 1997 Secondary Offering was completed, the Individual Defendants and other insiders and related parties continued to sell off more of their own Daou stock to pocket millions more in illegal insider trading proceeds for themselves.

42. As is further alleged herein, defendants improperly recognized revenue through the gross abuse of the POC method of accounting and recognized revenue before it was earned or before Daou was entitled to record the revenue in violation of GAAP. This artificially inflated the price of Daou stock so that Daou could sell a net $25.1 million in stock on its offerings, the Individual Defendants could dispose of more than $30.5 million worth of their own Daou common stock in the August 15, 1997 Secondary Offering and in the open market, other Daou affiliates and insiders could sell at least $24 million of their Daou stockholdings at inflated prices and defendants could make $137.7 million in corporate acquisitions.

DEFENDANTS' FRAUDULENT SCHEME AND COURSE OF BUSINESS

43. Each of the defendants is liable as a participant in a fraudulent scheme and course of business that operated as a fraud or deceit on purchasers of Daou stock, including the making of false and misleading statements and/or concealing material adverse facts. The fraudulent scheme and course of business: (i) deceived the investing public regarding Daou's finances and business: deceived the investing public regarding Daou's success in generating revenues and earnings; artificially inflated the price of Daou stock; (iv) caused lead plaintiffs and other members of the Class to purchase Daou stock at inflated prices; (v) permitted Daou and the Individual Defendants to sell 2,000,000 shares of stock on the February 13, 1997 IPO, 2,365,000 shares of stock in a August 15, 1997 Secondary Offering, and more shares of their holdings in the open market, all at artificially inflated prices; and (vi) permitted defendants to use only 6.6 million shares of stock to acquire 11 separate companies with a value of $137.7 million.

FALSE AND MISLEADING STATEMENTS DURING THE CLASS PERIOD

44. ***Defendants' false and misleading statements in Daou's initial public offering prospectus:***

(a) On February 13, 1997, defendants offered and sold in an IPO 2,000,000 shares of Daou's common stock to the public at $9 per share. In the Registration Statement and Prospectus issued in connection with the IPO and signed by defendants G. Daou, D. Daou, McGee and Moragne, defendants represented that Daou typically

provided its services on a fixed fee basis and that the Company recognized revenue using the POC accounting method:

> Contract revenue for the development and implementation of network solutions is recognized on the percentage-of-completion method with ***progress to completion measured by labor costs incurred to date compared to total estimated labor costs.*** Provisions for estimated losses on contracts, if any, are made during the period when the loss becomes probable and can be reasonably estimated. Revenues recognized in excess of amounts billed and project costs are classified as contract work in progress.

(b) Defendants further represented in the Prospectus that "[c]ertain contract payment terms may result in customer billing occurring at a pace slower than revenue recognition. The resulting revenue recognized in excess of amounts billed and project costs are classified as contract work in progress on the Company's balance sheet." ***For 4Q96, Daou reported in the Prospectus revenues of $6,954,000***, operating earnings of $126,000, accounts receivable of $4,085,000, and contract work in progress of $3,600,000. ***For FY96, Daou reported in the Prospectus revenues of $19.3 million.***

45. ***Reasons why defendants' statements in Daou's Prospectus were false and misleading***: Defendants' statement that Daou recognized revenue on the basis of labor costs incurred to date compared to total estimated labor costs and Daou's reported 4Q96 revenues of $6.95 million were false when made. The following facts, corroborated by the accounts of at least seven confidential witnesses, including accounting, engineering, and executive

personnel who were based in Daou's San Diego headquarters and at specific Company projects, confirm that, in truth, defendants failed to accurately employ POC accounting and that Daou's reported financial results were the result of defendants' improper revenue recognition in violation of GAAP and the Company's stated accounting policy:

(a) Defendants did not recognize revenue in accordance with POC accounting requirements or Daou's stated accounting policy. POC accounting and GAAP require that revenue not be recognized before it is earned and that all revenue recognized be based on the accurate measure of the labor costs to date compared to the total estimated labor costs for the project. According to CW5, a former engineer and assistant to one of Daou's Field Services executives, during 4Q96 and throughout FY97, POC revenue was recognized on Daou's contracts without regard to actual labor costs incurred or projected. CW5, who dealt with accounting for ongoing contracts under defendant McNeill, confirmed that defendants would automatically record 20% of the revenue from a contract upon contract signing, prior to any labor costs being incurred. Forty percent of the revenue from contracts was recognized immediately after any equipment was ordered and 50%-60% of the revenue was recognized as soon as the equipment was "burned-in" (configured and tested). CW5 confirmed that this revenue was recognized without regard to labor costs incurred.

(b) CW28, a former senior network engineer and project manager, who worked on Daou's Mercy Health Services project, confirmed that a fixed amount of revenue was recognized on contracts immediately upon signing, and that the revenue reported by defendants did not

reflect labor costs incurred compared to total estimated labor costs. CW9, a former Daou Vice President in the Sales Department, further confirmed the accuracy of CW5's and CW28's reports and identified that during this period defendants would recognize a fixed percentage of revenue immediately upon a contract signing and upon ordering equipment, even when no labor costs were incurred.

(c) 4Q96 revenue was artificially inflated to present the image of strong growth and to promote Daou's IPO. CW8, a Field Services Engineer during 4Q96, and CW3, a Senior Design Engineer during 4Q96, both confirmed that it was known throughout Daou at this time that G. Daou, D. Daou and McNeill were engaged in improper revenue recognition and that revenue on POC contracts was being recognized prematurely (before labor costs were incurred). According to CW5, CW9, CW28 and CW3, this premature and improper revenue recognition – violating GAAP and Daou's stated accounting policy – was not limited to one or two contracts, but was true for all or virtually all Daou projects, including the 4Q96 Mercy Health Services project.

(d) Defendants' statements about Daou's accounting policy and 4Q96 revenue were also false because, in addition to the immediate recognition of revenue after a contract was signed or equipment was ordered (and at a time when little or no labor costs had been incurred), defendants manipulated the actual labor costs incurred and estimated total labor costs. According to CW28 and CW12, both Field Services Engineers in 4Q96 and into FY97, the estimates of total labor costs provided by senior managers at project sites were routinely ignored for revenue recognition purposes. The estimates of total labor

hours used to calculate revenue by defendants G. Daou, D. Daou, McNeill and McGee were, according to CW12, grossly understated and did not reflect the opinions of the on-site managers. CW28 further confirms that, during this period, he was told by Field Services Vice President Mirabile, who worked at the direction of defendant McNeill, what percent complete his projects were (for revenue recognition purposes) and that these figures did not reflect the actual labor completed or labor required to complete the projects. According to CW28, based on his firsthand knowledge from Daou projects, the actual percentage of completion numbers were adjusted upward by Daou's senior executives to boost reported revenue.

(e) CW2, a training manager based in Daou's headquarters during 4Q96, reported that he was specifically told by both a senior-level network engineer and a Field Services project manager that defendants' revenue recognition on their projects was improper and was not based on Daou's stated POC accounting policy. As a result, according to CW2, both the network engineer and project manager left Daou after making their complaints about improper revenue recognition.

46. ***Defendants' knowledge of falsity***: Based on the reports of numerous witnesses, all of whom were former members of Daou's Executive, Accounting or Field Services staff, defendants not only knew that Daou failed to follow its stated POC accounting policy, but personally directed the violations of Daou's policy and GAAP in order to artificially inflate revenues.

(a) Defendants G. Daou, D. Daou, McNeill and McGee personally directed Daou's recognition of revenue, financial reporting and public statements. Not only were

these four defendants the top executives at Daou, but, according to CW23, a former executive assistant to one of the defendants, the Company was run "top to bottom" by G. Daou and D. Daou, with the assistance of McNeill and McGee. G. Daou and D. Daou, confirmed CW23, were particularly concerned with the Company's revenue recognition in advance of the IPO and on a quarterly basis, and made the final decisions on POC accounting revenue to be recognized.

(b) CW13 confirmed that McNeill provided G. Daou and D. Daou with all raw POC and revenue recognition figures and that, together with McGee, they personally determined what revenue Daou would publicly report. According to CW5, who reported to McNeill, McNeill, G. Daou and D. Daou paid particularly close attention to the POC and revenue recognition numbers, and were, with McGee, the only people at Daou who could determine how much revenue to publicly report. CW15 further confirmed that all decisions regarding recognition of revenue on Daou's contracts were made by McNeill, G. Daou and D. Daou.

(c) CW9, a regional Sales Vice President at Daou, confirmed that defendants G. Daou, D. Daou and McNeill not only made the decision on how much revenue to recognize without regard to any actual percentage of completion, but directed the practice of automatically recognizing revenue upon contract signing and ordering of equipment. Accordingly, from their own actions, these defendants knew their statements about Daou's accounting policy and revenue recognition were false and misleading when made.

(d) All of the defendants knew how Daou's results were progressing in 4Q96 and knew that the reported revenue could only be achieved by manipulating the Company's financial results. CW1, CW5, CW7, CW12, CW17 AND CW21 all confirm that both actual labor costs incurred/completed and the estimates used to falsify Daou's revenue recognition were recorded under the direction of McNeill and distributed to G. Daou, D. Daou, McGee and, periodically, to directors, including Moragne. Each employee on a Daou project was provided with a workbook containing the template for an Excel spreadsheet. The spreadsheet (the job costing sheet) contained categories for hours worked, along with travel and non-billable time. For each time period (initially Sunday to Sunday, later changed to bi-weekly), the Job Costing Sheet was provided to the project manager. The project manager would compile the billable time, make an estimate, based on the time and costs incurred to date, of the percent of the project that was complete and e-mail the information to Daou's project cost accounting staff in San Diego, who operated under McNeill. CW1, a project cost analyst, stated that the time and percentage of completion data was entered into the Company's ManFact accounting system. One or two days before the end of the month, Technical Services Vice President Ringwall and Field Services Vice President Mirabile would print out the ManFact reports containing actual labor and percent completion submitted by project managers, for the current month and quarter. According to CW1, CW3, CW4, CW7, CW16, the ManFact data was compiled into a Monthly Project Report which was sent to G. Daou, D. Daou, McGee, and McNeill at the close of each month and quarter. The Monthly Project Report contained columns for customer name, project number, contract amounts (total

revenue dollars), amount of revenue recognized in the six preceding months (identified by month), revenue to be recognized in the current month, and a 12-month forecast of revenue available to be recognized (identified by month). Based on the comprehensive Monthly Project Report, G. Daou, D. Daou, McNeill and McGee would adjust upward the percent completion for projects. According to CW1, who assisted in preparing the Monthly Project Report, after senior management's (G. Daou, D. Daou, McNeill, McGee) initial review of percentage of completion estimates, he would be directed by Ringwall or Mirabile to make manual adjustments in the ManFact system to increase the percentage of completion estimates submitted by project managers.

(e) CW1 further confirmed that Neil Cassidy, Vice President of Finance, and Wayne Walker, a Project Analyst in the Accounting Department who worked for McGee, would make jokes about the inflation of revenue recognition figures after defendants' review of the Monthly Project Report. Likewise, CW3, CW9, and CW 27 confirmed that G. Daou, D. Daou and McNeill monitored the actual and reported progress on POC contracts and it was generally believed within the Company that they were improperly recognizing revenue without regard to the actual status of ongoing projects.

(f) CW9 confirmed G. Daou and D. Daou were active, day-to-day managers of the Company and routinely met with McNeill and McGee. G. Daou maintained his own project accounts, including Western Tennessee Healthcare System, Mercy Health Services and the Stanford Medical Center. D. Daou oversaw mergers and acquisitions, using 6.6 million shares of Daou's artificially inflated stock to acquire 11 companies during the Class

DAOU ACQUISITIONS

Acquired Company	Date	Daou Shares Exchanged in Acquisition	Value of Exchanged Daou Shares	No. Of Shares "Saved" by Artificially Inflating Daou's Stock Price (1)
INTEGREX Systems Corp.	July 1997	700,000	$11,400,000	1,476,403
On-Line Networking, Inc.	Sept. 1997	150,000	$ 5,000,000	804,563
Sentient Systems, Inc.	March 1998	1,397,550	$30,000,000	4,329,827
Synexus, Inc.	March 1998	161,235	$ 3,000,000	411,503
Technology Management, Inc.	June 1998	1,078,963	$22,500,000	3,216,570
International HealthCare Systems, Inc.	June 1998	224,668	$ 4,685,080	669,773
Resources in Healthcare Innovations	June 1998	1,839,381	$38,357,000	5,483,452
Grand Isle Consulting, Inc.	June 1998	223,645	$ 4,663,730	666,720
Healthcare Transition Resources, Inc.	June 1998	275,662	$ 5,748,460	821,791
Innovative Systems Solutions, Inc.	June 1998	308,583	$ 6,434,970	919,934
Ultitech Resources Group, Inc.	June 1998	282,551	$ 5,892,120	842,329
TOTALS:		**6,642,238**	**$137,681,360**	**19,642,865**

* Based on 90 day average stock price from 10/28/98-1/26/99 of $5.24.

Period. CW4 further confirms that the [sic] G. Daou, D. Daou and McNeill ran the day-to-day Field Services and Sales operations and McGee ran the Accounting Department.

(g) G. Daou, D. Daou, McGee and Moragne each signed the Registration Statement and Prospectus attesting to the information therein and their knowledge of and basis for representing that Daou recognized revenue in line with its stated accounting policy and had 4Q96 revenue of $6.95 million.

47. ***Defendants' false and misleading statements about Daou's 1Q97 accounting and financial results***:

(a) On April 21, 1997, the Company issued a press release announcing its financial results for first quarter ended March 31, 1997, ***reporting revenues of $5,204,000***, operating losses of $500,000, accounts receivable of $3,372,000 and contract work in progress of $4,850,000:

> ***First-quarter revenues for the period ending March 31, 1997, were $5.2 million, an increase of 123 percent*** over the $2.3 million reported for the first quarter of 1996. The company reported a net loss of $232,000, or 2 cents per share. That compares with a net loss of $163,000, or 2 cents per share, for the same period in 1996.
>
> ***The increase in revenues was primarily attributable to the introduction of the company's information systems outsourcing services***, which the company did not provide in the first quarter of 1996, as well as an ***increase in network implementation revenues.***

The Release quoted defendant G. Daou as stating:

> "We are ***pleased with the progress we've made in implementing our 1997 corporate growth strategy***," said Georges Daou, chief executive officer of DAOU Systems.

(b) Subsequent to the release of its 1Q97 results, Daou held a conference call for analysts, money and portfolio managers, institutional investors and large shareholders to discuss Daou's 1Q results, its business and its prospects. During the call, and in follow-up conversations with analysts, G. Daou, D. Daou, McGee and McNeill stated:

- Daou's ***strong 1Q results were due to the success of the Company's growth strategy which had positioned the Company for strong growth going forward.***

- With its reorganization well underway, ***Daou was on track to achieve 1998 EPS of $0.42-$0.47.***

(c) On or about April 23, 1997, Daou filed its report on Form 10-Q for the quarter ended March 31, 1997, signed by defendants D. Daou and McGee. This report contained the same false financial information as was contained in the April 21, 1997 press release. Defendants represented that "[t]hese financial statements reflect all adjustments, consisting of only normal recurring adjustments which in the opinion of management, are necessary to fairly present the financial position [of Daou] at March 31, 1997 . . . and 1996."

48. ***Reasons why defendants' 1Q97 statements were false and misleading***: Daou's reported 1Q97 financial results and earnings forecasts and defendants'

statements attributing those results and forecasts to "strong growth" and new services were false when made. The following facts, corroborated by the accounts of at least 11 confidential witnesses, including accounting, engineering and executive personnel who were based in Daou's San Diego headquarters and at specific Company projects, confirm that, in truth, Daou's financial results and earnings forecasts were false and the result of defendants' improper revenue recognition in violation of GAAP and Daou's stated accounting policy:

(a) Defendants did not recognize revenue in accordance with POC accounting requirements or Daou's stated accounting policy. POC accounting and GAAP require that revenue not be recognized before it is earned and that all revenue recognized be based on the accurate measure of the labor costs to date compared to the total estimated labor costs for the project. According to CW5, a former engineer and assistant to one of Daou's Field Services executives, during 1Q97 revenue was recognized on Daou's contracts without regard to actual labor costs incurred or projected. CW5, who dealt with accounting for ongoing contracts under defendant McNeill, confirmed that defendants would automatically record 20% of the revenue from a contract upon contract signing, prior to any labor costs being incurred. Forty percent of the revenue from contracts was recognized immediately after any equipment was ordered and 50%-60% of the revenue was recognized as soon as the equipment was "burned-in" (configured and tested). CW5 confirmed that this revenue was recognized without regard to labor costs incurred.

(b) CW28, a former senior network engineer and project manager, who worked on Daou's Mercy Healthcare (Iowa) project in FY97, confirmed that a fixed amount of

revenue was recognized on contracts immediately upon signing, and that the revenue reported by defendants did not reflect labor costs incurred compared to total estimated labor costs. Former Daou Sales executive CW9 further confirmed the accuracy of CW5 and CW28 reports, and identified that during this period defendants would recognize a fixed percentage of revenue immediately upon a contract signing and upon ordering equipment, even when no labor costs were incurred.

(c) 1Q97 revenue was artificially inflated to present the image of strong growth and to boost Daou's stock price. CW8, a Field Services Engineer during 1Q97, and CW3, a Senior Design Engineer during 1Q97, both confirmed that it was known throughout Daou at this time that G. Daou, D. Daou and McNeill were engaged in improper revenue recognition and that revenue on POC contracts was being recognized prematurely (before labor costs were incurred). According to CW3, CW5, CW9 and CW 28, this premature and improper revenue recognition – violating GAAP and Daou's stated accounting policy – was not limited to one or two contracts, but was true for all or virtually all Daou projects, including the 1Q97 Floyd Healthcare (Georgia) project.

(d) Had Daou reported revenue in line with the amount it was entitled to bill customers pursuant to its contracts, actually reflecting contract work done to date, revenue would have been only $4.1 million, 21% less than publicly reported ($5.2 million). CW13, CW17 and CW27 confirmed that the dramatic growth in Daou's work in progress account, increasing $1.1 million from 4Q96 to 1Q97, was the result of defendants' premature recognition of revenue. The work in progress account was comprised almost entirely of contract amounts Daou had recognized

as revenue but for which it was not entitled to bill because little or no labor had yet taken place and the percentage of the project actually complete was lower than the percentage completion numbers defendants used to calculate reported revenue.

(e) The reported increase in revenue during 1Q97 was primarily attributable to defendants' improper recognition of revenue, not "corporate growth" or new outsourcing services. At least 21% of Daou's publicly reported revenue was the result of prematurely recognizing revenue without any basis in actual labor costs incurred or actual estimated total labor costs.

(f) Defendants' statements about Daou's 1Q97 revenue were also false because, in addition to the immediate recognition of revenue after a contract was signed or equipment was ordered (and at a time when little or no labor costs had been incurred), defendants manipulated the actual labor costs incurred and estimated total labor costs. According to CW12 and CW28, both Field Services Engineers in FY97, the estimates of total labor costs provided by senior managers at project sites were routinely ignored for revenue recognition purposes. The estimates of total labor hours used to calculate revenue by defendants G. Daou, D. Daou, McNeill and McGee were, according to CW12, grossly understated and did not reflect the opinions of the on-site managers. CW28 further confirmed that, during this period, he was told by Field Services Vice President Mirabile, who worked at the direction of McNeill, what percent complete his projects were (for revenue recognition purposes) and that these figures did not reflect the actual labor completed or labor required to complete the projects. According to CW28, based on his firsthand knowledge from Daou projects, the

actual percentage of completion numbers were adjusted upward by Daou's senior executives to boost reported revenue.

(g) CW2, a training manager based in Daou's headquarters during 1Q97, reported that he was specifically told by both a senior-level network engineer and a Field Services project manager that defendants' revenue recognition on their projects was improper and was not based on Daou's stated POC accounting policy. As a result, according to CW2, both the network engineer and project manager left Daou after making their complaints about improper revenue recognition.

(h) Daou was not on track to achieve FY98 EPS of $0.42-$0.47 because defendants were prematurely recognizing revenue, in violation of GAAP and the Company's stated accounting policy, on contracts including the Floyd Healthcare (Georgia) and Atlantic Healthcare projects, that would take at least two years to complete. As a result, according to CW3 and CW24, project managers were told that projects were "closed" for billing purposes, when the projects were actually far from completion. CW17, a financial analyst in Daou's San Diego headquarters, confirmed that, at the direction of McNeill, labor costs incurred after 100% of the revenue on the project was recognized were dumped into accounts receivable. After defendants finally reported Daou's disastrous 3Q98 results and revealed the financial impact of their accounting manipulations, Daou reported a FY98 loss of $0.33 per share.

49. ***Defendants' knowledge of falsity***: Based on the reports of numerous witnesses, all of whom were former members of Daou's Executive, Accounting or Field

Services staff, defendants not only knew that the Company's reported financial results and earnings forecast were based on fraudulent accounting, but personally directed the violations of Daou's stated accounting policy and GAAP in order to artificially inflate revenues:

(a) Defendants G. Daou, D. Daou, McNeill and McGee personally directed Daou's recognition of revenue, financial reporting and public statements. Not only were these four defendants the top executives at Daou, but, according to CW23, a former executive assistant to one of the defendants, the Company was run "top to bottom" by G. Daou and D. Daou, with the assistance of McNeill and McGee. G. Daou and D. Daou, confirmed CW23, were particularly concerned with the Company's revenue recognition and exceeding the Company's projected 1Q97 revenue and earnings and made the final decisions on POC accounting revenue to be recognized.

(b) CW13 confirmed that McNeill provided G. Daou and D. Daou with all raw POC and revenue recognition figures and, together with McGee, they personally determined what revenue Daou would publicly report. According to CW5, who reported to McNeill, McNeill, G. Daou and D. Daou paid particularly close attention to the POC and revenue recognition numbers, and were, with McGee, the only people at Daou who could determine how much revenue to publicly report. CW15 further confirmed that all decisions regarding recognition of revenue on Daou's contracts were made by McNeill, G. Daou and D. Daou.

(c) CW9, a regional Sales Vice President at Daou, confirmed that defendants G. Daou, D. Daou and McNeill not only made the decision on how much revenue

to recognize without regard to any actual percentage of completion, but directed the practice of automatically recognizing revenue upon contract signing and ordering of equipment. Accordingly, from their own actions, these defendants knew their statements about Daou' [sic] accounting policy and revenue recognition were false and misleading when made.

(d) All of the defendants knew how Daou's results were progressing in 1Q97 and knew that the reported revenue could only be achieved by manipulating the Company's financial results. CW1, CW5, CW7, CW12, CW17 and CW21 all confirm that both actual labor costs incurred/completed and the estimates used to falsify Daou's revenue recognition were recorded under the direction of McNeill and distributed to G. Daou, D. Daou, McGee and, periodically, to directors including Moragne. Each employee on a Daou project was provided with a workbook containing the template for an Excel spreadsheet. The spreadsheet (the job costing sheet) contained categories for hours worked, along with travel and non-billable time. For each time period (initially Sunday to Sunday, later changed to bi-weekly), the spreadsheet was provided to the project manager. The project manager would compile the billable time, make an estimate, based on the time and costs incurred to date of the percent of the project that was complete, and e-mail the information to Daou's project cost accounting staff in San Diego, who operated under COO McNeill. CW1, a project cost analyst, stated that the time and percentage of completion data was entered into the Company's ManFact accounting system. One or two days before the end of the month, Vice Presidents Ringwall and Mirabile would print out the ManFact reports containing actual labor and percent

completion submitted by project managers, for the current month and quarter. According to CW3, CW4, CW7 and CW16, the ManFact data was compiled into a Monthly Project Report which was sent to G. Daou, D. Daou, McGee, and McNeill at the close of each month and quarter. The Monthly Project Report contained columns for customer name, project number, contract amounts (total revenue dollars), amount of revenue recognized in the six preceding months (identified by month), revenue to be recognized in the current month, and a 12-month forecast of revenue available to be recognized (identified by month). Based on the comprehensive Monthly Project Report, G. Daou, D. Daou, McNeill and McGee would adjust upward the percent completion for projects. According to CW1, who assisted in preparing the Monthly Project Report, after senior management's (G. Daou, D. Daou, McNeill, McGee) initial review of percentage of completion estimates, he would be directed by Ringwall or Mirabile to make manual adjustments in the ManFact system to increase the percentage of completion estimates submitted by project managers.

(e) CW1 further confirmed that Vice President Neil Cassidy and Project Analyst Wayne Walker would routinely make jokes about the inflation of revenue recognition figures after defendants' review of the Monthly Project Report. Likewise, CW3, CW9 and CW27 confirmed that G. Daou, D. Daou and McNeill monitored the actual and reported progress on POC contracts and it was generally believed within the Company that they were improperly recognizing revenue without regard to the actual status of ongoing projects.

(f) CW9 confirmed G. Daou and D. Daou were active, day-to-day managers of the Company and routinely

met with McNeill and McGee. G. Daou maintained his own project accounts, including Western Tennessee Healthcare System, Mercy Health Services and the Stanford Medical Center. D. Daou oversaw mergers and acquisitions, using 6.6 million shares of Daou's artificially inflated stock to acquire 11 companies during the Class Period. CW4 further confirms that the [sic] G. Daou, D. Daou and McNeill ran the day-to-day Field Services and Sales operations and McGee ran the Accounting Department.

(g) During the conference call and subsequent conversations with analysts and money and portfolio managers, defendants G. Daou, D. Daou, McGee and McNeill presented themselves as the persons at Daou most knowledgeable about the Company's reported revenue, earnings expectations, financial results and business. CW14, a former analyst who covered Daou, confirmed that these defendants, and in particular McGee, presented themselves as knowledgeable about all aspects of the Company's finances, including earnings and revenue recognized under POC accounting.

(h) D. Daou and McGee signed the report on Form 10-Q for 1Q97 attesting to the information therein and their knowledge of and basis for representing that Daou recognized revenue in line with its stated policy and had 1Q97 revenue of $5.2 million.

50. ***Defendants' false and misleading statements about Daou's 2Q97 accounting and financial results***:

(a) On July 16, 1997, through the *Business Wire*, the Company announced its financial results for the second quarter ended June 30, 1997, ***reporting revenues***

of $6,004,000, operating losses of $112,000, accounts receivable of $5,593,000 and contract work in progress of $5,297,000:

> The company posted ***second-quarter and year-to-date revenue of $6 million and $11.2 million respectively, increases over the previous year of 15 percent and 49 percent respectively***. Net income for the second quarter was $58,000 with a net loss for the year to date of $174,000.
>
> That translates to ***second-quarter earnings per share of 1 cent,*** the same as for the second quarter of the previous year. The year-to-date earnings per share are a loss of 2 cents, which compares with a loss of 1 cent for the same period in 1996.
>
> ***The increase in revenue is primarily attributable to an increase in the number of network management and implementation contracts that the company has secured with such major health care organizations as Harris Methodist Health System, Centura Health and St. Mary's Health Network.***
>
> These and other management contracts have ***boosted the company's recurring revenue to 33 percent for the year to date.***
>
> * * *
>
> ***"We are continuing to roll out our corporate strategy," said Georges Daou,*** chief executive officer of DAOU Systems. "All our planned regional offices have been established within the past 120 days and are productive."

(b) On or about July 16, 1997, Daou filed its report on Form 10-Q for the quarter ended June 30, 1997, signed by defendants D. Daou and McGee. This report contained the same false financial information as was contained in the July 16, 1997 press release. Defendants represented that "[t]hese financial statements reflect all adjustments, consisting of only normal recurring adjustments which in the opinion of management, are necessary to fairly present the financial position [of Daou] at June 30, 1997 and 1996."

(c) Subsequent to the release of its 2Q97 results, Daou held a conference call for analysts, money and portfolio managers, institutional investors and large shareholders to discuss Daou's 2Q results, its business and its prospects. During the call – and in follow-up conversations with analysts – G. Daou, D. Daou, McGee and McNeill stated:

- Daou's ***better than expected 2Q results were due to strong business momentum in developing new business.***

- Daou's days sales outstanding (the measure of the estimated time to collect receivables ("DSO")) had increased to 89 days but ***this was due to more billing activity in June 1997 and not due to any problems.***

- ***Daou was on track to achieve 1998 EPS of $0.42-$0.60.***

- Contract work-in-progress totaled $6.25 million, but $4.4 million of that total was hardware purchased for which no revenue had been recognized.

51. ***Reasons why defendants' 2Q97 statements were false and misleading:*** Daou's reported 2Q97 financial results and its earnings forecasts and statements attributing those results and forecasts to increased contracts and strong business momentum were false when made. The following facts, corroborated by the accounts of at least 12 confidential witnesses, including accounting, engineering and executive personnel who were based in Daou's San Diego headquarters and at specific Company projects, confirm that, in truth, Daou's financial results and earnings forecasts were false and the result of defendants' improper revenue recognition in violation of GAAP and Daou's stated accounting policy.

(a) Defendants did not recognize revenue in accordance with POC accounting requirements or Daou's stated accounting policy. POC accounting and GAAP require that revenue not be recognized before it is earned and that all revenue recognized be based on the accurate measure of the labor costs to date compared to the total estimated labor costs for the project. According to CW5, a former engineer and assistant to one of Daou's Field Services executives, during 2Q97 revenue was recognized on Daou's contracts without regard to actual labor costs incurred or projected. CW5, who dealt with accounting for ongoing contracts under defendant McNeill, confirmed that defendants would automatically record 20% of the revenue from a contract upon contract signing, prior to any labor costs being incurred. Forty percent of the revenue from contracts was recognized immediately after any equipment was ordered, and 50%-60% of the revenue was recognized as soon as the equipment was "burned-in" (configured and tested). CW5 confirmed that this revenue was recognized without regard to labor costs incurred.

(b) CW28, a former senior network engineer and project manager, who worked on Daou's Mercy Health Services project, confirmed that a fixed amount of revenue was recognized on contracts immediately upon signing, and that the revenue reported by defendants did not reflect labor costs incurred compared to total estimated labor costs. Former Daou Sales executive CW9 further confirmed the accuracy of CW5 and CW28's reports, and stated that during this period defendants would recognize a fixed percentage of revenue upon a contract signing and upon ordering equipment, even when no labor costs were incurred.

(c) 2Q97 revenue was artificially inflated to present the image of strong growth and boost Daou's stock price. CW8, a Field Services Engineer during 2Q97, and CW3, a senior Design Engineer during 2Q97, both confirmed that it was known throughout Daou at this time that G. Daou, D. Daou and McNeill were engaged in improper revenue recognition and that revenue on POC contracts was being recognized prematurely (before labor costs were incurred). According to CW3, CW5, CW9 and CW28, this premature and improper revenue recognition – violating GAAP and Daou's stated accounting policy – was not limited to one or two contracts, but was true for all or virtually all Daou projects, including the 2Q97 Mercy Health Services project.

(d) Had Daou reported revenue in line with the amount it was entitled to bill customers pursuant to its contracts, actually reflecting contract work done to date, revenue would have been only $5.5 million, 9% less than publicly reported ($6.0 million), CW13, CW17 and CW27 confirmed that the dramatic growth in Daou's work in progress account, increasing $447,000 from 1Q97 to 2Q97,

was the result of defendants' premature recognition of revenue. The work in progress account was comprised almost entirely of contract amounts Daou had recognized as revenue but for which it was not entitled to bill because little or no labor had yet taken place and the percentage of the project actually complete was lower than the percentage completion numbers defendants used to calculate reported revenue.

(e) The reported increase in revenue during 2Q97 was primarily attributable to defendants' improper recognition of revenue, not "increased contracts" and "strong business momentum." At least 9% of Daou's publicly reported revenue, representing nearly all of the increase from Daou's 2Q96, was the result of prematurely recognizing revenue without any basis in actual labor costs incurred or actual total labor costs estimated.

(f) Revenue on Daou's Centura Health project was recognized in 2Q97 when no actual labor costs were incurred. According to CW5, who worked with Daou's Field Services executives (including McNeill and Mirabile), in late June 1997 Daou was struggling to make its projected 2Q97 earnings and revenue numbers. In the last week of June, Vice President of Field Services, Mirabile, at G. Daou's direction, directed CW5 to find a new project with equipment in Daou's San Diego warehouse. At the request of G. Daou, three Field Services employees (salaried) were offered $100 each to come in on the last Saturday in June 1997, unpack and plug in computer equipment ordered for the Centura Health project and immediately record 8 hours of labor each on their job costing sheets. According to CW5, the purpose of this deceptive practice was to justify recognizing 30%-40% of the revenue on the Centura Health project in 2Q97.

(g) CW8 corroborated CW5's account of defendants' improper recognition of revenue on the Centura Health project in 2Q97. According to CW8, he and two or three other Field Services engineers were directed by Mirabile, at the request of McNeill or G. Daou, to go to Daou's San Diego warehouse, plug in some computers, turn them on and leave. CW8 says he and the other Field Services personnel were told to bill eight hours each to the Centura Health project, just for plugging in and turning on the computers, and were promised $100 each for doing so. CW8 further stated that he was never paid the $100 and when he followed up about the payment with Mirabile's assistant, he was told to "forget about it" and "forget it ever happened." According to CW8, the only rationale for the request that he and others bill eight hours work for no real labor was to prematurely recognize revenue on the Centura Health project.

(h) Defendants' statements about Daou's 2Q97 revenue were also false because, in addition to the immediate recognition of revenue after a contract was signed or equipment was ordered (and at a time when little or no labor costs had been incurred), defendants manipulated the actual labor costs incurred and estimated total labor costs. According to CW28 and CW12, both Field Services Engineers in FY97, the estimates of total labor costs provided by senior managers at project sites were routinely ignored for revenue recognition purposes. The estimates of total labor hours used to calculate revenue by defendants G. Daou, D. Daou, McNeill and McGee were, according to CW12, grossly understated and did not reflect the opinions of the on-site managers. CW28 further confirms that, during this period, he was told by Field Services Vice President Mirabile, who worked at the

direction of McNeill, what percent complete his projects were (for revenue recognition purposes) and that these figures did not reflect the actual labor completed or labor required to complete the projects. According to CW28, based on his firsthand knowledge from Daou projects, the actual percentage of completion numbers were adjusted upward by Daou's senior executives to boost reported revenue.

(i) Daou was not on track to achieve FY98 EPS of $0.42-$0.47 because defendants were prematurely recognizing revenue, in violation of GAAP and the Company's stated accounting policy, on contracts including the Centura Health project, that would take over a year to complete. As a result, according to CW3 and CW24, project managers were told that projects were "closed" for billing purposes, when the projects were actually far from completion. CW17, a financial analyst in Daou's San Diego headquarters, confirmed that, at the direction of McNeill, labor costs incurred after 100% of the revenue on the project was recognized were dumped into accounts receivable. After defendants finally reported Daou's disastrous 3 Q98 results and revealed the financial impact of their accounting manipulations, Daou reported a FY98 loss of $0.33 per share.

(j) CW2, a training manager based in Daou's headquarters during 2Q97, reported that he was specifically told by both a senior-level network engineer and a Field Services project manager that defendants' revenue recognition on their projects was improper and was not based on Daou's stated POC accounting policy. As a result, according to CW2, both the network engineer and project manager left Daou after making their complaints about improper revenue recognition.

(k) Daou's work in progress account was primarily unbilled receivables, not hardware purchases for which no revenue had been recognized. CW4 and CW5 both confirm that Daou recognized a fixed percentage of revenue immediately upon ordering and receiving equipment for a project. CW13 and CW17, as detailed above, further confirmed that the work in progress account was comprised almost entirely of contract amounts Daou had recognized as revenue but for which it was not entitled to bill because little or no labor had yet taken place and the percentage of the project actually complete was lower than the percentage completion numbers defendants used to calculate reported revenue.

52. ***Defendants' knowledge of falsity:*** Based on the reports of numerous witnesses, all of whom are former members of Daou's Executive, Accounting or Field Services staff, defendants not only knew that the Company's reported financial results and earnings forecast for 2Q97 were based on fraudulent accounting, but personally directed the violations of Daou's stated accounting policy and GAAP in order to artificially inflate revenues.

(a) Defendants G. Daou, D. Daou, McNeill and McGee personally directed Daou's recognition of revenue, financial reporting and public statements. Not only were these four defendants the top executives at Daou but, according to CW23, a former executive assistant to one of the defendants, the Company was run "top to bottom" by G. Daou and D. Daou, with the assistance of McNeill and McGee. G. Daou and D. Daou, confirmed CW23, were particularly concerned with the Company's revenue recognition and exceeding the Company's projected 2Q97 revenue and earnings, and made the final decisions on POC accounting revenue to be recognized.

(b) CW13 confirmed that McNeill provided G. Daou and D. Daou with all raw POC and revenue recognition figures and, together with McGee, they personally determined what revenue Daou would publicly report. According to CW5, who reported to McNeill, McNeill, G. Daou and D. Daou paid particularly close attention to the POC and revenue recognition numbers, and were, with McGee, the only people at Daou who could determine how much revenue to publicly report. CW15 further confirmed that all decisions regarding recognition of revenue on Daou's contracts were made by McNeill, G. Daou and D. Daou.

(c) CW9, a regional Sales Vice President at Daou, confirmed that defendants G. Daou, D. Daou and McNeill not only made the decision on how much revenue to recognize without regard to any actual percentage of completion, but directed the practice of automatically recognizing revenue upon contract signing and ordering of equipment. Accordingly, from their own actions, these defendants knew their statements about Daou' accounting policy and revenue recognition were false and misleading when made.

Defendants knew that Daou had prematurely recognized 100% of the revenue on projects that were not near completion. Between 1Q97 and 2Q97, Daou's accounts receivable, which defendants publicly reported and were aware of, increased $2.2 million. According to CW17, a former financial analyst at Daou, defendants knew that the accounts receivable balance at Daou represented labor costs incurred on a project ***after*** 100% of the revenue had been recognized under POC accounting. CW13 confirmed that defendants' premature recognition of 100% of the

revenue on contracts resulted in continuing labor costs being allocated to accounts receivable.

(e) As described above, Daou's reported 2Q97 revenue was artificially inflated by the recognition of 30%-40% of the revenue on the Company's Centura Health project when no real labor costs had been incurred and the project was not 30%-40% complete. According to CW5, who had personal knowledge of the Centura Health account, defendants G. Daou and McNeill knew of and directed Field Services engineers to falsely bill labor hours to the Centura Health project in order to justify the premature recognition of revenue and inflate Daou's 2Q97 revenue.

(f) All of the defendants knew how Daou's results were progressing in 2Q97 and knew that the reported revenue could only be achieved by manipulating the Company's financial results. CW1, CW5, CW7, CW12, CW17 and CW21 all confirm that both actual labor costs incurred/completed and the estimates used to falsify Daou's revenue recognition were recorded under the direction of McNeill and distributed to G. Daou, D. Daou, McGee and, periodically, to directors, including Moragne. Each employee on a Daou project was provided with a workbook containing the template for an Excel spreadsheet. The spreadsheet (the job costing sheet) contained categories for hours worked, along with travel and non-billable time. For each time period (initially Sunday to Sunday, later changed to bi-weekly), the spreadsheet was provided to the project manager. The project manager would compile the billable time, make an estimate, based on the time and costs incurred to date, of the percent of the project that was complete and e-mail the information to Daou's project cost accounting staff in San Diego, who operated under COO McNeill. CW1, a project cost analyst,

stated that the time and percentage of completion data were entered into the Company's ManFact accounting system. One or two days before the end of the month, Vice Presidents Ringwall and Mirabile would print out the ManFact reports containing actual labor and percent completion submitted by project managers for the current month and quarter. According to CW1, CW3, CW4, CW7 and CW16, the ManFact data was compiled into a Monthly Project Report which was sent to G. Daou, D. Daou, McGee and McNeill at the close of each month and quarter. The Monthly Project Report contained columns for customer name, project number, contract amounts (total revenue dollars), amount of revenue recognized in the six preceding months (identified by month), revenue to be recognized in the current month, and a 12-month forecast of revenue available to be recognized (identified by month). Based on the comprehensive Monthly Project Report, G. Daou, D. Daou, McNeill and McGee would adjust upward the percent completion for projects. According to CW1, who assisted in preparing the Monthly Project Report, after senior management's (G. Daou, D. Daou, McNeill, McGee) initial review of percentage of completion estimates, he would be directed by Ringwall or Mirabile to make manual adjustments in the ManFact system to increase the percentage of completion estimates submitted by project managers.

(g) CW1 further confirmed that Vice President Neil Cassidy and Project Analyst Wayne Walker would make jokes about the inflation of revenue recognition figures after defendants' review of the Monthly Project Report. Likewise, CW3, CW9 and CW27 confirmed that G. Daou, D. Daou and McNeill monitored the actual and reported progress on POC contracts and it was generally

believed within the Company that they were improperly recognizing revenue without regard to the actual status of ongoing projects.

(h) CW9 confirmed G. Daou and D. Daou were active, day-to-day managers of the Company and routinely met with McNeill and McGee. G. Daou maintained his own project accounts, including Western Tennessee Healthcare System, Mercy Health Services and the Stanford Medical Center. D. Daou oversaw mergers and acquisitions, using 6.6 million shares of Daou's artificially inflated stock to acquire 11 companies during the Class Period. CW4 further confirms that G. Daou, D. Daou and McNeill ran the day-to-day Field Services and Sales operations and McGee ran the Accounting Department.

(i) During the conference call and subsequent conversations with analysts and money and portfolio managers, defendants G. Daou, D. Daou, McGee and McNeill presented themselves as the persons at Daou most knowledgeable about the Company's reported revenue, earnings expectations, financial results and business. CW14, a former analyst who covered Daou, confirmed that these defendants, and in particular McGee, presented themselves as knowledgeable about all aspects of the Company's finances, including earnings and revenue recognized under POC accounting.

(j) At the same time as defendants were making their positive, albeit false statements about Daou's 2Q97 financial results and business prospects, defendants, led by D. Daou, acquired INTEGREX Systems Corp. in exchange for 700,000 shares of stock valued at the time at $11.4 million.

(k) Within three weeks of making their positive statements about Daou's 2Q97 financial results and business prospects, defendants D. Daou, G. Daou, McGee and Moragne sold $1.29 million shares of their personal Daou stock to an unsuspecting public, pocketing $25 million.

(l) D. Daou and McGee signed the report on Form 10-Q for 2Q97 attesting to the information therein and their knowledge of and basis for representing that Daou recognized revenue in line with its stated policy and that it had 2Q97 revenue of $6.0 million.

53. On August 15, 1997, the Company filed a Registration Statement and Prospectus for an offering of 2,365,000 shares of the Company's common stock, 1,865,000 shares of which were being offered by certain insiders including the Individual Defendants. In the Registration Statement and Prospectus issued in connection with the offering, defendants again represented that Daou typically provided its services on a fixed fee basis and that the Company recognized revenue using the POC method:

> Contract revenue for the development and implementation of network solutions is recognized on the percentage-of-completion *method* with *progress to completion measured by labor costs incurred to date compared to total estimated labor costs.* Provisions for the estimated losses on contracts, if any, are made during the period when the loss becomes probable and can be reasonably estimated. Revenues recognized in excess of amounts billed and project costs are classified as contract work in progress.

The Prospectus also contained Daou's false financial results for the first six months of 1997.

54. Defendants' statements in the Prospectus were, again, false and misleading because, as described with regard to Daou's February 13, 1997 Prospectus and 1Q97 and 2Q97 accounting and financial results, defendants did not comply with Daou's stated accounting policy and improperly recognized revenues utilizing the POC methodology in violation of GAAP. The Registration Statement was signed by D. Daou and McGee, who, as described with regard to Daou's 1Q97 ¶¶8-49 and 2Q97 statements ¶¶51-52, knew their statements were false and misleading when made.

55. The insiders who dumped thousand [sic] of shares in this offering and reaped millions of dollars included defendants G. Daou, D. Daou, McGee, and Moragne, who sold shares for more than $25 million. Specifically, G. Daou and D. Daou each sold 479,937 shares, McGee sold 12,600 shares and entities controlled by Moragne sold 316,836 shares.

56. In September 1997, with Daou stock trading at artificially inflated prices as a result of defendants' false and misleading statements, defendants, led by D. Daou, acquired On-Line Networking, Inc. in exchange for 150,000 shares of stock valued at $5,000,000.

57. ***Defendants' false and misleading statements about Daou's 3Q97 accounting and financial results:***

(a) On October 15, 1997, through the ***Business Wire,*** **the Company announced** ***record revenue and earnings for the third quarter of fiscal year 1997,***

reporting ***revenues of $11,299,000***, operating income of $66,000, accounts receivable of $6,294,000 and contract work in progress of $10,737,000:

> The company posted ***third-quarter and year-to-date revenue of $11.3 million and $27.2 million respectively, increases over the previous year of 61 percent and 41 percent*** respectively. Net income, fully taxed before one-time merger and tax-related costs for the third quarter, was $578,000, with a net income for the year to date of $488,000. That translates to ***third-quarter earnings per share of 5 cents,*** an increase of 2 cents per share over the third quarter of the previous year. The ***year-to-date earnings per share are 4 cents,*** which compares to 6 cents for the same period in 1996.
>
> The increase in revenue is primarily attributable to the ***growth and success of DAOU's national sales and marketing strategy,*** the introduction of new services and the ***continued market demand for the company's core technology.*** The firm's client base has grown to more than 600 organizations.
>
> * * *
>
> ***"Our strategy is unfolding as planned,"*** said Georges Daou, chief executive officer of DAOU Systems. "New services such as our desktop support contract with Harris Methodist Health System in Dallas have been well received by the market. ***Our core business continues to grow,*** as is illustrated by our major network design and implementation project at Centura Health, which is Colorado's largest healthcare

organization. And our merger with INTEGREX is leading to new projects as healthcare organizations seek to integrate voice, video and data networks."

(b) Subsequent to the release of its 3Q97 results, Daou held a conference call for analysts, money and portfolio managers, institutional investors and large shareholders to discuss Daou's 3Q results, its business and its prospects. During the call – and in follow-up conversations with analysts – G. Daou, D. Daou, McGee and McNeill stated:

- ***Daou's results had well exceeded analyst estimates because Daou was continuing to sign new contracts and business momentum was exceptional.***

- Daou was ***on track to report increased EPS of $0.50-$0.62 in 1998.***

These statements had a dramatic impact on the Company's stock price. On the day following the announcement, the Company's stock price jumped nearly $3 to close at $28-1/8.

(c) On or about November 4, 1997, Daou filed its report on Form 10-Q for the quarter ended September 30, 1997, signed by defendants D. Daou and McGee. This report contained the same false financial information as was contained in the October 15, 1997 press release. Defendants represented that "[t]hese financial statements reflect all adjustments, consisting of only normal recurring adjustments which in the opinion of management, are necessary to fairly present the financial position [of Daou] at September 30, 1997 and the results of operations for the

three and nine-month periods ended September 30, 1997 and 1996."

58. ***Reasons why defendants' 3Q97 statements were false and misleading:*** Daou's reported 3Q97 financial results and earnings forecasts, claims of dramatic year-to-year revenue growth and statements attributing the Company's "success" to exceptional business growth were false and misleading when made. The following facts, corroborated by the accounts of at least 15 confidential witnesses, including accounting, engineering and executive personnel who were based in Daou's San Diego headquarters and at specific Company projects, confirm that, in truth, Daou's financial results and earnings forecasts were false and misleading and the result of defendants' improper revenue recognition in violation of GAAP and Daou's stated accounting policies, not exceptional business growth or Company success.

(a) Defendants did not recognize revenue in accordance with POC accounting requirements or Daou's stated accounting policy. POC accounting and GAAP require that revenue not be recognized before it is earned and that all revenue recognized be based on the accurate measure of the labor costs to date compared to the total estimated labor costs for the project. According to CW5, a former engineer and assistant to one of Daou's Field Services executives, during 3Q97 revenue was recognized on Daou's contracts without regard to actual labor costs incurred or projected. CW5, who dealt with accounting for ongoing contracts under defendant McNeill, confirmed that defendants would automatically record 20% of the revenue from a contract upon contract signing, prior to any labor costs being incurred. Forty percent of the revenue from contracts was recognized immediately after any

equipment was ordered, and 50%-60% of the revenue was recognized as soon as the equipment was "burned-in" (configured and tested). CW5 confirmed that this revenue was recognized without regard to labor costs incurred.

(b) CW28, a former senior network engineer and project manager, who worked on Daou's Mercy Health Services project, confirmed that a fixed amount of revenue was recognized on contracts immediately upon signing, and that the revenue reported by defendants did not reflect labor costs incurred compared to total estimated labor costs. Former Daou Sales executive CW9 further confirmed the accuracy of CW5 and CW28's reports, and stated that during this period defendants would recognize a fixed percentage of revenue upon a contract signing and upon ordering equipment, even when no labor costs were incurred.

(c) 3Q97 revenue was artificially inflated to present the image of strong growth and boost Daou's stock price. CW8, a Field Services Engineer during 3Q97, and CW3, a senior Design Engineer during 3Q97, both confirmed that it was known throughout Daou at this time that G. Daou, D. Daou and McNeill were engaged in improper revenue recognition and that revenue on POC contracts was being recognized prematurely (before labor costs were incurred). According to CW3, CW5, CW9 and CW28, this premature and improper revenue recognition – violating GAAP and Daou's stated accounting policy – was not limited to one or two contracts, but was true for all or virtually all Daou projects.

(d) Had Daou reported revenue in line with the amount it was entitled to bill customers pursuant to its contracts, actually reflecting contract work done to date,

revenue for 3Q97 would have been only $5.9 million, 48% less than publicly reported ($11.3 million). CW13, CW17 and CW27 confirmed that the dramatic growth in Daou's work in progress account, increasing $5.4 million from 2Q97 to 3Q97, was the result of defendants' premature recognition of revenue. The work in progress account was comprised almost entirely of contract amounts Daou had recognized as revenue but for which it was not entitled to bill because little or no labor had yet taken place and the percentage of the project actually complete was lower than the percentage completion numbers defendants used to calculate reported revenue.

(e) The reported increase in revenue during 3Q97 was attributable to defendants' improper recognition of revenue, not "corporate growth" or new outsourcing services. At least 48% of Daou's publicly reported revenue, representing the entire amount of increased revenue from 2Q97, was the result of prematurely recognizing revenue without any basis in actual labor costs incurred or actual total estimated labor costs.

(f) Business was not growing or exceptional, and the Centura Health project was losing money. According to CW10, a former account manager for the Centura Health project, Daou was losing money on the Centura Health account as a result of recognizing revenue before labor costs were actually incurred. As detailed under 2Q97, CW5 and CW8 both described how defendants recognized 30%-40% of the revenue from the Centura Health contract in 2Q97 based on no more than false records of hours worked and plugging in and turning on computers destined for the project.

(g) CW5 confirmed that, as in 2Q97, during the final weeks of the 3Q97, defendants were desperate to report revenue growth. At the time, according to CW5, Daou, led by G. Daou, was in the process of negotiating a multimillion contract with Candler Health Systems. During the final days of 3Q97, all of the equipment for the Candler Health Systems project was ordered and Daou immediately recognized 20% of the contract price, approximately $1-1.5 million, as revenue, before any contract was signed. By the following quarter, after the Candler Health Systems project revenue had been reported, Daou still did not have a contract and had incurred no actual labor costs. Daou never received the contract and eventually was forced to sell the equipment at a loss.

(h) Defendants' statements about Daou's accounting policy and 3Q97 revenue were also false because, in addition to the immediate recognition of revenue after a contract was signed or equipment was ordered (and at a time when little or no labor costs had been incurred), defendants manipulated the actual labor costs incurred and estimated total labor costs. According to CW12 and CW28, both Field Services Engineers in FY97, the estimates of total labor costs provided by senior managers at project sites were routinely ignored for revenue recognition purposes. The estimates of total labor hours used to calculate revenue by defendants G. Daou, D. Daou, McNeill and McGee were, according to CW12, grossly understated and did not reflect the opinions of the on-site managers. CW28 further confirms that, during this period, he was told by Field Services Vice President Mirabile, who worked at the direction of McNeill, what percent complete his projects were (for revenue recognition purposes) and that these figures did not reflect the actual labor completed

or labor required to complete the projects. According to CW28, based on his firsthand knowledge from Daou projects, the actual percentage of completion numbers were adjusted upward by Daou's senior executives to boost reported revenue.

(i) Daou was not on track to achieve FY98 EPS of $0.50-$0.62 because defendants were prematurely recognizing revenue, in violation of GAAP and the Company's stated accounting policy, on contracts including the Candler Health Systems project, that would take over one year to complete. As a result, according to CW3 and CW24, project managers were told that projects were "closed" for billing purposes, when the projects were actually far from completion. CW17, a financial analyst in Daou's San Diego headquarters, confirmed that, at the direction of McNeill, labor costs incurred after 100% of the revenue on the project was recognized were dumped into accounts receivable. After defendants finally reported Daou's disastrous 3Q98 results and revealed the financial impact of their accounting manipulations, Daou reported a FY98 loss of $0.33 per share.

(j) CW2, a training manager based in Daou's headquarters during 3Q97, reported that he was specifically told by both a senior-level network engineer and a Field Services project manager that defendants' revenue recognition on their projects was improper and was not based on Daou's stated POC accounting policy. As a result, according to CW2, both the network engineer and project manager left Daou after making their complaints about improper revenue recognition.

(k) Daou's work in progress account was primarily unbilled receivables, not hardware purchases for which

no revenue had been recognized. CW4 and CW5 both confirm that Daou recognized a fixed percentage of revenue immediately upon ordering and receiving equipment for a project. CW13 and CW17, as detailed above, further confirmed that the work in progress account was comprised almost entirely of contract amounts Daou had recognized as revenue but for which it was not entitled to bill because little or no labor had yet taken place and the percentage of the project actually complete was lower than the percentage completion numbers defendants used to calculate reported revenue.

59. ***Defendants' knowledge of falsity:*** Based on the reports of numerous witnesses, all of whom are former members of Daou's Executive, Accounting or Field Services staff, defendants not only knew that the Company's reported financial results and earnings forecasts were based on fraudulent accounting, but personally directed the violations of Daou's stated accounting policy and GAAP in order to artificially inflate revenues:

(a) Defendants G. Daou, D. Daou, McNeill and McGee personally directed Daou's recognition of revenue, financial reporting and public statements. Not only were these four defendants the top executives at Daou, but, according to CW23, a former executive assistant to one of the defendants, the Company was run "top to bottom" by G. Daou and D. Daou, with the assistance of McNeill and McGee. G. Daou and D. Daou, confirmed CW23, were particularly concerned with the Company's revenue recognition and exceeding the Company's projected revenue and earnings, and made the final decisions on POC accounting revenue to be recognized.

(b) CW13 confirmed that McNeill provided G. Daou and D. Daou with all raw POC and revenue recognition figures and that, together with McGee, they personally determined what revenue Daou would publicly report. According to CW5, who reported to McNeill, McNeill, G. Daou and D. Daou paid particularly close attention to the POC and revenue recognition numbers and were, with McGee, the only people at Daou who could determine how much revenue to publicly report. CW15 further confirmed that all decisions regarding recognition of revenue on Daou's contracts were made by McNeill, G. Daou and D. Daou.

(c) CW9, a regional Sales Vice President at Daou, confirmed that defendants G. Daou, D. Daou and McNeill not only made the decision on how much revenue to recognize without regard to any actual percentage of completion, but directed the practice of automatically recognizing revenue upon contract signing and ordering of equipment. Accordingly, from their own actions, these defendants knew their statements about Daou' accounting policy and revenue recognition were false and misleading when made.

(d) Defendants knew that Daou had prematurely recognized 100% of the revenue on projects that were not near completion. Between 2Q97 and 3Q97, Daou's accounts receivable, which defendants publicly reported and were aware of, increased $701,000. According to CW17, a former financial analyst at Daou, defendants knew that the accounts receivable balance at Daou represented labor costs incurred on a project ***after*** 100% of the revenue had been recognized under POC accounting. CW13 confirmed that defendants' premature recognition of

100% of the revenue on contracts resulted in continuing labor costs being allocated to accounts receivable.

(e) As described above, Daou's reported 3Q97 revenue was artificially inflated by the recognition of 20% of the revenue of the Company's unsigned contract for a project with Candler Health Systems. According to CW5, who had personal knowledge of the proposed Candler Health Systems project, defendant G. Daou knew of and directed the end-of-the-quarter purchase of equipment and revenue recognition and knew no contract had been signed with Candler.

(f) According to CW14, during 3Q97 McGee prepared an earnings model that he sent by facsimile to analysts who covered or reported on Daou. The monthly earnings model included projected revenue and EPS on a quarterly basis for FY98 and FY97.

(g) All of the defendants knew how Daou's results were progressing in 3Q97 and knew that the reported revenue could only be achieved by manipulating the Company's financial results. CW1, CW7, CW9, CW12, CW17 and CW21 all confirm that both actual labor costs incurred/completed and the estimates used to falsify Daou's revenue recognition were recorded under the direction of McNeill and distributed to G. Daou, D. Daou, McGee and, periodically, to directors, including Moragne. Each employee on a Daou project was provided with a workbook containing the template for an Excel spreadsheet. The spreadsheet (the job costing sheet) contained categories for hours worked, along with travel and non-billable time. For each time period (initially Sunday to Sunday, later changed to bi-weekly), the spreadsheet was provided to the project manager. The project manager

would compile the billable time, make an estimate, based on the time and costs incurred to date, of the percent of the project that was complete and e-mail the information to Daou's project cost accounting staff in San Diego, who operated under COO McNeill. CW1, a project cost analyst, stated that the time and percentage of completion data was entered into the Company's ManFact accounting system. One or two days before the end of the month, Vice Presidents Ringwall and Mirabile would print out the ManFact reports containing actual labor and percent completion submitted by project managers, for the current month and quarter. According to CW1, CW3, CW4, CW6, CW7, the ManFact data was compiled into a Monthly Project Report which was sent to G. Daou, D. Daou, McGee, and McNeill at the close of each month and quarter. The Monthly Project Report contained columns for customer name, project number, contract amounts (total revenue dollars), amount of revenue recognized in the six preceding months (identified by month), revenue to be recognized in the current month, and a 12-month forecast of revenue available to be recognized (identified by month). Based on the comprehensive Monthly Project Report, G. Daou, D. Daou, McNeill and McGee would adjust upward the percent completion for projects. According to CW1, who assisted in preparing the Monthly Project Report, after senior management's (G. Daou, D. Daou, McNeill, McGee) initial review of percentage of completion estimates, he would be directed by Ringwall or Mirabile to make manual adjustments in the ManFact system to increase the percentage of completion estimates submitted by project managers.

(h) CW1 further confirmed that Vice President Neil Cassidy and Project Analyst Wayne Walker would

make jokes about the inflation of revenue recognition figures after defendants' review of the Monthly Project Report. Likewise, CW3, CW9 and CW27 confirmed that G. Daou, D. Daou and McNeill monitored the actual and reported progress on POC contracts and it was generally believed within the Company that they were improperly recognizing revenue without regard to the actual status of ongoing projects.

(i) CW9 confirmed G. Daou and D. Daou were active, day-to-day managers of the Company and routinely met with McNeill and McGee. G. Daou maintained his own project accounts, including Western Tennessee Healthcare, Mercy Health Services and the Stanford Medical Center. D. Daou oversaw mergers and acquisitions, using 6.6 million shares of Daou's artificially inflated stock to acquire 11 companies during the Class Period. CW4 further confirms that G. Daou, D. Daou and McNeill ran the day-to-day Field Services and Sales operations and McGee ran the Accounting Department.

(j) During the conference call and subsequent conversations with analysts and money and portfolio managers, defendants G. Daou, D. Daou, McGee and McNeill presented themselves as the persons at Daou most knowledgeable about the Company's reported revenue, earnings expectations, financial results and business. CW14, a former analyst who covered Daou, confirmed that these defendants, and in particular McGee, presented themselves as knowledgeable about all aspects of the Company's finances, including earnings and revenue recognized under POC accounting.

(k) D. Daou and McGee signed the report on Form 10-Q for 3Q97 attesting to the information therein and their knowledge of and basis for representing that Daou recognized revenue in line with its stated policy and had 3Q97 revenue of $11.3 million.

(l) Within one month of their positive statements about Daou's 3Q97 financial results, defendants and other insiders took advantage of Daou's higher stock price. On November 17, 1997, defendant Moragne disposed of 11,408 shares of his Daou stock at $31.69 per share for proceeds of $361,519. On November 19, 1997, Joseph Daou the father of G. Daou and D. Daou, sold 300,000 shares of his stockholdings at $28.15 per share for proceeds of $8,445,000.

60. Defendants' false and misleading statements about Daou's 4Q and FY97 accounting and financial results:

(a) On January 21, 1998, through the *Business Wire*, Daou published ***record fourth quarter and year-end financial results***. The Company posted ***fourth quarter and year-end revenue of $14.5 million and $41.7 million,*** respectively, increases over the previous year of 60% and 47%, respectively. Net income was $664,000 for the fourth quarter with a net income for the year of $87,000.

> ***DAOU attributes the increase in revenue primarily to continued market demand for the company's core services,*** the success of the firm's acquisition strategy, continued momentum from recent investments in national sales and marketing programs, and the introduction of new services.

* * *

> *"Obviously, **1997 has been an outstanding year for our company,"** said **Georges Daou,*** chief executive officer of DAOU Systems. ***"We believe we have established a successful business model and a strong foundation that will help carry our momentum into 1998 and beyond."***

(b) Subsequent to the release of its 4Q and FY97 results, Daou held a conference call for analysts, money and portfolio managers, institutional investors and large Daou shareholders to discuss Daou's 4Q and FY97 results, its business and its prospects. During the call – and in follow-up conversations with analysts – G. Daou, D. Daou, McGee and McNeill stated:

- Despite a small earnings shortfall, ***Daou's revenue growth continued and orders for 1998 were strong.***

- Daou's acquisitions, both those already completed and those in the pipeline for 1998, were all high margin and would ***contribute to Daou's revenue and earnings growth.***

- Daou was seeing substantial increases in prices for its design services, which would contribute to revenues, margins and earnings growth in 1998 and 1999.

- ***Daou was on track to report 1998 and 1999 EPS of $0.62 and $0.90-$0.92, respectively.***

(c) On January 22, 1998, securities analysts issued reports on Daou, which were based on and repeated information provided by G. Daou, D. Daou, McGee and

McNeill in the conference call and in follow-up conversations. These reports projected earnings for Daou and rated Daou as follows:

(d) On or about March 10, 1998, Daou filed its Form 10-K for the fiscal year end. December 31, 1997, signed by defendants G. Daou, D. Daou, McGee, and Moragne. This report contained the same year end false financial information as was contained in the January 21, 1998 press release and was false and misleading for the same reasons detailed herein.

(e) On March 20, 1998, H&Q analyst D. Godsey visited Daou's San Diego headquarters and met with Daou management including G. Daou, D. Daou and McGee. During the visit, Daou management told Godsey that:

- ***Daou was having a strong quarter, and the Company had enormous long-term opportunities.***

- The ***outlook for the Company had never been brighter.***

- ***Estimates of $0.50 and $0.80 for 1998 and 1999, respectively, were the downside possibilities if the Company should have problems closing deals*** – thus Daou was clearly ***on track to report strong revenue and earnings growth.***

(f) On March 23, 1998, H&Q issued a report on Daou written by D. Godsey which was based on and repeated Daou management's statements to Godsey. The report forecast ***1998 EPS of $0.62*** and rated Daou a "strong buy."

61. ***Reasons why defendants' statements were false and misleading:*** Daou's reported 4Q and FY97 financial results and earnings forecasts, claims of dramatic year-to-year revenue growth and statements attributing the Company's "outstanding year," "strong quarter"

Firm	Date	1998 EPS	1999 EPS	Rating	Analyst
Adams, Harkness & Hill, Inc.	1/22/98	$0.62	$0.92	Buy	C. Trafton
Legg Mason Wood Walker, Inc.	1/22/98	$0.62	$0.92	Buy	J. Ackerman
BT Alex. Brown	1/22/98	$0.62	$0.90	Strong Buy	A. Gallo
Cowen & Co.	1/22/98	$0.55	$0.90	Strong Buy	S. Tyagi
Hambrecht & Quist	1/22/98	$0.62	N/A	Strong Buy	D. Godsey
Banc America Robertson Stephens	1/22/98	$0.62	$0.92	Buy	M. Samols

and bright outlook to increasing revenue from market demand were false and misleading when made. The following facts, corroborated by the accounts of at least 18 confidential witnesses, including accounting, engineering and executive personnel who were based in Daou's San Diego headquarters and at specific Company projects, confirm that, in truth, Daou's financial results and earnings forecasts were false and misleading and were the result of defendants' improper revenue recognition in violation of Daou's stated accounting policy and GAAP.

(a) Defendants did not recognize revenue in accordance with POC accounting requirements or Daou's stated accounting policy. POC accounting and GAAP require that revenue not be recognized before it is earned and that all revenue recognized be based on the accurate measure of the labor costs to date compared to the total estimated labor costs for the project. According to CW5, a former engineer and assistant to one of Daou's Field Services executives, during 4Q97 revenue was recognized on Daou's contracts without regard to actual labor costs incurred or projected. CW5, who dealt with accounting for ongoing contracts under defendant McNeill, confirmed that defendants would automatically record 20% of the revenue from a contract upon contract signing, prior to any labor costs being incurred. Forty percent of the revenue from contracts was recognized immediately after any equipment was ordered, and 50%-60% of the revenue was recognized as soon as the equipment was "burned-in" (configured and tested). CW5 confirmed that this revenue was recognized without regard to labor costs incurred.

(b) CW28, a former senior network engineer and project manager, who worked on Daou's Mercy Health Services project, confirmed that a fixed amount of revenue

was recognized on contracts immediately upon signing, and that the revenue reported by defendants did not reflect labor costs incurred compared to total estimated labor costs. Former Sales executive CW9 further confirmed the accuracy of CW5 and CW28's reports, and stated that during this period defendants would recognize a fixed percentage of revenue upon a contract's signing and upon ordering equipment, even when no labor costs were incurred.

(c) 4Q97 and FY97 revenue was artificially inflated to present the image of strong growth and boost Daou's stock price. CW8, a Field Services Engineer during 4Q97, and CW3, a senior Design Engineer during 4Q97, both confirmed that it was known throughout Daou at this time that G. Daou, D. Daou and McNeill were engaged in improper revenue recognition and that revenue on POC contracts was being recognized prematurely (before labor costs were incurred). According to CW3, CW5, CW9 and CW28, this premature and improper revenue recognition – violating GAAP and Daou's stated accounting policy – was not limited to one or two contracts, but was true for all or virtually all Daou projects.

(d) Had Daou reported revenue in line with the amount it was entitled to bill customers pursuant to its contracts, actually reflecting contract work done to date, revenue for 4Q97 would have been only $12.8 million, 12% less than publicly reported ($14.5 million) and total revenue for FY97 would have been only $33.1 million, 21% less than publicly reported ($41.7). CW13, CW17 and CW27 that the dramatic growth in Daou's work in progress account, increasing $1.7 million from 3Q97 to 4Q97 and $8.6 million during FY97, was the result of defendants' premature recognition of revenue. The work in

progress account was comprised almost entirely of contract amounts Daou had recognized as revenue but for which it was not entitled to bill because little or no labor had yet taken place and the percentage of the project actually complete was lower than the percentage completion numbers defendants used to calculate reported revenue.

(e) The reported increase in revenue during 4Q97 was primarily attributable to defendants' improper recognition of revenue, not the purported "outstanding year" or market demand. At least 12% of Daou's publicly reported revenue for 4Q97 and 21% of reported revenue for FY97 was the result of prematurely recognizing revenue without any basis in actual labor costs incurred or actual total estimated labor costs.

(f) Business momentum was not exceptional, and the Centura Health project continued to lose money. According to CW10, a former account manager during 4Q97, Daou was losing money on the Centura Health account as a result of defendants' recognition of revenue before labor costs were actually incurred. As detailed under 2Q97, CW5 and CW8 both described how defendants recognized 30%-40% of the revenue of the Centura Health contract in 2Q97 based on no more than false records of hours worked and plugging in and turning on computers destined for the project.

(g) Daou's 4Q97 revenues and future outlook were impacted by Candler Health System's decision not to contract with Daou. As described with regard to defendants' false and misleading statements regarding 3Q97, at the end of 3Q97 defendants had ordered equipment for a then under-negotiation contract with Candler Health Systems. Daou immediately recognized revenue on the

project without regard to the Company's POC accounting policy and despite the fact that no contract was signed. The equipment ordered by Daou for the Candler Health Systems project sat in Daou's warehouse throughout 4Q97 and was never used on any Daou project.

(h) According to CW5 and CW20, by 4Q97 Daou had recognized 100% of the revenue on its Mercy Health Services project, but the project was not near completion. Revenue had been recognized in advance of actual labor costs incurred and without regard to actual labor costs necessary to complete the project. As a result, according to CW20, who was a Field Services engineer on the Mercy Health Services project, requisite onsite engineers were withdrawn from the project and, according to CW5 labor costs incurred were "overbudget," going to Daou's accounts receivable balance.

(i) CW16, a financial analyst under McNeill, confirmed that the projects he reviewed for which Daou had recognized 95% of the revenue were nowhere near 95% complete. This was well known among Daou's financial analysts and consultants as confirmed by CW12 and CW17.

(j) Defendants' statements about Daou's 4Q and FY97 revenue were also false because, in addition to the immediate recognition of revenue after a contract was signed or equipment was ordered (and at a time when little or no labor costs had been incurred), defendants manipulated the actual labor costs incurred and estimated total labor costs. According to CW12 and CW28, both Field Services Engineers in FY97, the estimates of total labor costs provided by senior managers at project sites were routinely ignored for revenue recognition purposes. The

estimates of total labor hours used to calculate revenue by defendants G. Daou, D. Daou, McNeill and McGee were, according to CW12, grossly understated and did not reflect the opinions of the on-site managers. CW28 further confirms that, during this period, he was told by Field Services Vice President Mirabile, who worked at the direction of McNeill, what percent complete his projects were (for revenue recognition purposes) and that these figures did not reflect the actual labor completed or labor required to complete the projects. According to CW28, based on his firsthand knowledge from Daou projects, the actual percentage of completion numbers were adjusted upward by Daou's senior executives to boost reported revenue.

(k) Daou was not on track to achieve FY98 EPS of $0.62 or FY99 EPS of $0.90-$0.92 because defendants were prematurely recognizing revenue in violation of GAAP and the Company's stated accounting policy on contracts that would take years to complete. As a result according to CW3 and CW24, project managers were told that projects were "closed" for billing purposes, when the projects were actually far from completion. CW17, a financial analyst in Daou's San Diego headquarters, confirmed that, at the direction of McNeill, labor costs incurred after 100% of the revenue on the project was recognized were dumped into accounts receivable. After defendants finally reported Daou's disastrous 3Q98 results and revealed the financial impact of their accounting manipulations, Daou reported a FY98 loss of $0.33 per share. For FY99 Daou reported a loss of $0.52 per share, nowhere close to the projected earnings of $0.90-$0.92.

(l) CW2, a training manager based in Daou's headquarters during 4Q97, reported that he was specifically told by both a senior-level network engineer and a Field Services project manager that defendants' revenue recognition on their projects was improper and was not based on Daou's stated POC accounting policy. As a result, according to CW2, both the network engineer and project manager left Daou after making their complaints about improper revenue recognition.

(m) Daou's work in progress account was primarily unbilled receivables, not hardware purchases for which no revenue had been recognized. CW4 and CW5 both confirm that Daou recognized a fixed percentage of revenue immediately upon ordering and receiving equipment for a project. CW13 and CW17, as detailed above, further confirmed that the work in progress account was comprised almost entirely of contract amounts Daou had recognized as revenue but for which it was not entitled to bill because little or no labor had yet taken place and the percentage of the project actually complete was lower than the percentage completion numbers defendants used to calculate reported revenue.

62. ***Defendants' knowledge of falsity:*** Based on the reports of numerous witnesses, all of whom were former members of Daou's Executive, Accounting or Field Services staff, defendants not only knew that the Company's reported financial results and earnings forecast were based on fraudulent accounting, but personally directed the violations of GAAP in order to artificially inflate revenues.

(a) Defendants G. Daou, D. Daou, McNeill and McGee personally directed Daou's recognition of revenue,

financial reporting and public statements. Not only were these four defendants the top executives at Daou, but, according to CW23, a former executive assistant to one of the defendants, the Company was run "top to bottom" by G. Daou and D. Daou, with the assistance of McNeill and McGee. G. Daou and D. Daou, confirmed CW23, were particularly concerned with the Company's revenue recognition and exceeding the Company's projected revenue and earnings, and made the final decisions on POC accounting revenue to be recognized.

(b) On January 29, 1998, only one week after defendants released Daou's "outstanding" 4Q and FY97 results and analysts rated the Company a "strong buy" based on meetings with G. Daou, D. Daou, McGee and McNeill, G. Daou and D. Daou further liquidated their holdings. Specifically, G. Daou and D. Daou each sold 75,000 shares of their Daou stock for proceeds of $2,429,000.

(c) CW13 confirmed that McNeill provided G. Daou and D. Daou with all raw POC and revenue recognition figures and, together with McGee, they personally determined what revenue Daou would publicly report. According to CW5, who reported to McNeill, McNeill, G. Daou and D. Daou paid particularly close attention to the POC and revenue recognition numbers, and were, with McGee, the only people at Daou who could determine how much revenue to publicly report. CW15 further confirmed that all decisions regarding recognition of revenue on Daou's contracts were made by McNeill, G. Daou and D. Daou.

(d) CW9, a regional Sales Vice President at Daou, confirmed that defendants G. Daou, D. Daou and

McNeill not only made the decision on how much revenue to recognize without regard to any actual percentage of completion, but directed the practice of automatically recognizing revenue upon contract signing and ordering of equipment. Accordingly, from their own actions, these defendants knew their statements about Daou's accounting policy and revenue recognition were false and misleading when made.

(e) Defendants knew that Daou had prematurely recognized 100% of the revenue on projects that were not near completion. Between 3Q97 and 4Q97, Daou's accounts receivable, which defendants publicly reported and were aware of, increased $4.767 million. According to CW17, a former financial analyst at Daou, defendants knew that the accounts receivable balance at Daou represented labor costs incurred on a project ***after*** 100% of the revenue had been recognized under POC accounting. CW13 confirmed that defendants' premature recognition of 100% of the revenue on contracts resulted in continuing labor costs being allocated to accounts receivable.

(f) According to CW14, during 4Q97 McGee prepared an earnings model that he sent by facsimile to analysts who covered or reported on Daou. The monthly earnings model included projected revenue and EPS on a quarterly basis for FY98 and FY97.

(g) All of the defendants knew how Daou's results were progressing in 4Q97 and knew that the reported revenue could only be achieved by manipulating the Company's financial results. CW1, CW5, CW7, CW12, CW17, and CW21 all confirm that both actual labor costs incurred/completed and the estimates used to falsify Daou's revenue recognition were recorded under the

direction of McNeill and distributed to G. Daou, D. Daou, McGee and periodically to directors, including Moragne. Each employee on a Daou project was provided with a workbook containing the template for an Excel spreadsheet. The spreadsheet (the job costing sheet) contained categories for hours worked, along with travel and non-billable time. For each time period (initially Sunday to Sunday, later changed to bi-weekly), the spreadsheet was provided to the project manager. The project manager would compile the billable time, make an estimate, based on the time and costs incurred to date, of the percent of the project that was complete and e-mail the information to Daou's project cost accounting staff in San Diego, who operated under COO McNeill. CW1, a project cost analyst, stated that the time and percentage of completion data was entered into the Company's ManFact accounting system. One or two days before the end of the month, Vice Presidents Ringwall and Mirabile would print out the ManFact reports containing actual labor and percent completion submitted by project managers for the current month and quarter. According to CW1, CW3, CW4, CW7 and CW16, the ManFact data was compiled into a Monthly Project Report which was sent to G. Daou, D. Daou, McGee, and McNeill at the close of each month and quarter. The Monthly Project Report contained columns for customer name, project number, contract amounts (total revenue dollars), amount of revenue recognized in the six preceding months (identified by month), revenue to be recognized in the current month, and a 12-month forecast of revenue available to be recognized (identified by month). Based on the comprehensive Monthly Project Report, G. Daou, D. Daou, McNeill and McGee would adjust upward the percent completion for projects. According to CW1, who assisted in preparing the Monthly Project

Report, after senior management's (G. Daou, D. Daou, McNeill, McGee) initial review of percentage of completion estimates, he would be directed by Ringwall or Mirabile to make manual adjustments in the ManFact system to increase the percentage of completion estimates submitted by project managers.

(h) CW1 further confirmed that Vice President Neil Cassidy and Project Analyst Wayne Walker would make jokes about the inflation of revenue recognition figures after defendants' review of the Monthly Project Report. Likewise, CW3, CW9 and CW27 confirmed that G. Daou, D. Daou and McNeill monitored the actual and reported progress on POC contracts and it was generally believed within the Company that they were improperly recognizing revenue without regard to the actual status of ongoing projects.

(i) CW9 confirmed G. Daou and D. Daou were active, day-to-day managers of the Company and routinely met with McNeill and McGee. G. Daou maintained his own project accounts, including Western Tennessee Healthcare, Mercy Health Services and the Stanford Medical Center. D. Daou oversaw mergers and acquisitions, using 6.6 million shares of Daou's artificially inflated stock to acquire 11 companies during the Class Period. CW4 further confirms that G. Daou, D. Daou and McNeill ran the day-to-day Field Services and Sales operations and McGee ran the Accounting Department.

(j) During the conference call and subsequent conversations with analysts and money and portfolio managers, defendants G. Daou, D. Daou, McGee and McNeill presented themselves as the persons at Daou most knowledgeable about the Company's reported revenue,

earnings expectations, financial results and business. CW14, a former analyst who covered Daou, confirmed that these defendants, and in particular McGee, presented themselves as knowledgeable about all aspects of the Company's finances, including earnings and revenue recognized under POC accounting.

(k) G. Daou, D. Daou, McGee and Moragne signed the report on Form 10-K for FY97 attesting to the information therein and their knowledge of and basis for representing that Daou recognized revenue in line with its stated policy and had 4Q97 revenue of $14.5 million.

63. In March 1998, with Daou stock trading at artificially inflated prices as a result of defendants' false and misleading statements, defendants, led by D. Daou, acquired Sentient Systems, Inc. and Synexus, Inc. in exchange for 1.6 million shares of stock valued, at the time, at $33.0 million.

64. ***Defendants' false and misleading statements about Daou's 1Q98 accounting and financial reports:***

(a) On April 23, 1998, through the *Business Wire*, the Company announced ***record results for the first quarter of 1998*** reporting ***revenues of $18,063,000,*** operating income of $454,000, accounts receivable of $16,546,000 and contract work in progress of $20,126,000:

> The company posted ***first-quarter revenue of $18.1 million, a 79 percent increase*** over the $10.1 million reported for the first quarter of 1997. Net income for the quarter was $1.4 million (before one-time merger costs of $1.7 million), compared to net income of $160,000 for the same period last year.

Diluted first-quarter earnings per share (before one-time merger costs of $0.13 per share) are $0.10 per share, which compares to a net income of $0.01 per share for the same period in 1997.

DAOU attributes the increase in revenue and earnings to a broader penetration of the healthcare technology market, new service offerings, recent mergers that provide customers with a more comprehensive line of services, and an increased utilization of the company's growing sales force.

* * *

"We have begun the year in solid fashion," said Georges Daou, chief executive officer of DAOU Systems. "Our customer base grew, our marketshare is expanded and demand for our services appears high. Furthermore, we have continued our mergers and acquisitions strategy, which will provide us with an even larger foothold in the market, as well as an end-to-end set of technology solutions for our customers."

(b) On April 23, 1998, subsequent to the release of its 1Q98 results, Daou hosted a conference call for analysts, money and portfolio managers, institutional investors and large Daou shareholders to discuss Daou's 1Q results, business and prospects. During the call, and in follow-up conversations with analysts, G. Daou, D. Daou, McGee and McNeill stated:

- ***Daou's spectacular 1Q results were due to strong performance in its core networking services business,*** as well as new service offerings.

- ***Daou was successfully adding new customers and its momentum was increasing.***

- ***Although contract work-in-progress increased to $20.1 million, this was no cause for concern as unbilled receivables represented only $900,000 of this amount, and the rest was hardware purchased and labor hours for which no revenue had been recognized.***

- ***Daou was on track to report EPS of $0.62 and $0.90-$0.95 in 1998 and 1999, respectively.***

(c) On April 24-27, 1998, securities analysts issued reports on Daou, which were based on and repeated information provided by G. Daou, D. Daou, McGee and McNeill in the conference call and in follow-up conversations. These reports projected earnings for Daou and rated Daou as follows:

(d) On or about May 15, 1998, Daou filed its report on Form 10-Q for the quarter ended March 31, 1998, signed by defendants D. Daou and McGee. Defendants represented that "[t]hese financial statements reflect all adjustments, consisting of only normal recurring adjustments which in the opinion of management, are necessary to fairly present the financial position [of Daou] at March 31, 1998 and the result of operations for the three-month periods ended March 31, 1998 and 1997." This report contained the same false information as was contained in the April 23, 1998 press release and was false and misleading for the same reasons detailed herein.

65. ***Reasons why defendants' 1Q98 statements were false and misleading***: Daou's reported 1Q98 financial results and earnings forecasts, statements regarding dramatic year-to-year revenue growth, increasing momentum and "spectacular" results and claims that increasing work in progress were no cause for concern were false and misleading when made. The following facts, corroborated by the accounts of at least 16 confidential witnesses, including accounting, engineering and executive personnel based in Daou's headquarters and at specific Company projects, confirm that, in truth, Daou's financial results and earnings forecasts were false and misleading and the result of defendants' improper venue recognition in violation of Daou's stated accounting policy and GAAP.

(a) Defendants did not recognize revenue in accordance with POC accounting requirements or Daou's stated accounting policy. POC accounting and GAAP requires that revenue not be recognized before it is earned and that all revenue recognized be based on the accurate measure of the labor costs to date compared to the total

estimated labor costs for the project. According to CW5, a former engineer and assistant to one of Daou's Field Services executives, revenue was recognized on Daou's contracts without regard to actual labor costs incurred or projected. CW5, who dealt with accounting for ongoing contracts under defendant McNeill, confirmed that defendants would automatically record 20% of the revenue from a contract upon contract signing, prior to any labor costs being incurred. Forty percent of the revenue from contracts was recognized immediately after any equipment was ordered, and 50%-60% of the revenue was recognized as soon as the equipment was "burned-in" (configured and tested). CW5 confirmed that this revenue was recognized without regard to labor costs incurred.

(b) CW28, a former senior network engineer and project manager, confirmed that a fixed amount of revenue was recognized on contracts immediately upon signing, and that the revenue reported by defendants did not reflect labor costs incurred compared to total estimated labor costs. Former Sales executive CW9 further confirmed the accuracy of CW5 and CW28s' reports, and identified that during this period defendants would recognize a fixed percentage of revenue upon a contract signing and upon ordering equipment, even when no labor costs were incurred.

(c) 1Q98 revenue was artificially inflated to present the image of strong growth and boost Daou's stock price. CW8, a Field Services Engineer, and CW3, a senior Design Engineer, both confirmed that it was known throughout Daou at this time that G. Daou, D. Daou and McNeil were engaged in improper revenue recognition and that revenue on POC contracts was being recognized prematurely (before labor costs were incurred). According

to CW3, CW5, CW9 and CW28, this premature and improper revenue recognition – violating GAAP and Daou's stated accounting policy – was not limited to one or two contracts, but was true for all or virtually all Daou projects.

(d) Had Daou reported revenue in line with the amount it was entitled to bill customers pursuant to its contracts, actually reflecting contract work done to date, revenue for 1Q98 would have been only $10.3 million, 43% less than publicly reported ($18.1 million). CW13, CW17 and CW27 confirmed that the dramatic growth in Daou's work in progress account, increasing $7.8 million from 4Q97 to 1Q98, was the result of defendants' premature recognition of revenue. The work in progress account was comprised almost entirely of contract amounts Daou had recognized as revenue but for which it was not entitled to bill because little or no labor had yet taken place and the percentage of the project actually complete was lower than the percentage completion numbers defendants used to calculate reported revenue.

(e) The reported increase in revenue during 1Q98 was primarily attributable to defendants' improper recognition of revenue, not the purported "outstanding year" or market demand. At least 43% of Daou's publicly reported revenue for 1Q98 was the result of prematurely recognizing revenue without any basis in actual labor costs incurred or actual total estimated labor costs. But for the improperly recognized revenue, Daou would have had to report flat year-to-year growth.

(f) According to CW5 and CW20, by 4Q97 and into 1Q98 Daou had recognized 100% of the revenue on its Mercy Health Services project, but the project was not

near completion. Revenue had been recognized in advance of actual labor costs incurred and without regard to actual labor costs necessary to complete the project. As a result, according to CW20, who was a Field Services engineer on the Mercy Health Services project, requisite onsite engineers were withdrawn from the project and, according to CW5, labor costs incurred were "overbudget," going to Daou's accounts receivable balance.

(g) Similarly, CW22 confirmed that personnel were pulled from Daou's Huntington Memorial Hospital (California) project before the project was completed, apparently because Daou had already recognized 100% of the revenue from the project contract.

(h) According to CW24, in 1Q98 Daou began to recognize revenue on a $2,000,000 call center project with the University of Chicago (Illinois), when no contract had been signed. According to CW24, McNeill closely monitored the University of Chicago project and knew that the strategic plan for implementing the project was not completed until April 1998 (2Q98) and, as of June 30, 1998 (2Q98), Daou and the University of Chicago still had not agreed on the terms of the project. Later in the project, when CW24 submitted a job costing sheet detailing labor costs incurred, she was told by Field Services department executives, operating under McNeill, that the project had been "closed" for billing purposes, even though the project was not close to completion.

(i) CW1, who received and entered POC data in the Company's ManFact accounting system, stated that by 1Q98 Daou had recognized 100% of the revenue on the Company's St. Mary's Health Network (Nevada) project, but that Field Services continued to submit job costing

sheets, because the project was not 100% complete. According to CW1, approximately $4 million in labor costs were incurred after Daou had recognized 100% of the revenue from the St. Mary's Health Network contract.

(j) Defendants' statements about Daou's 1Q98 revenue were also false because, in addition to the immediate recognition of revenue after a contract was signed or equipment was ordered (and at a time when little or no labor costs had been incurred), defendants manipulated the actual labor costs incurred and estimated total labor costs. According to CW12 and CW 28, both Field Services engineers, the estimates of total labor costs provided by senior managers at project sites were routinely ignored for revenue recognition purposes. The estimates of total labor hours used to calculate revenue by defendants G. Daou, D. Daou, McNeill and McGee were, according to CW12; grossly understated and did not reflect the opinions of the on-site managers. CW28 further confirms that, during this period, he was told by Field Services Vice President Mirabile, who worked at the direction of McNeill, what percent complete his projects were (for revenue recognition purposes) and that these figures did not reflect the actual labor completed or labor required to complete the projects. According to CW28, based on his firsthand knowledge from Daou projects, the actual percentage of completion numbers were adjusted upward by Daou's senior executives to boost reported revenue.

(k) Daou was not on track to achieve FY98 EPS of $0.62 or FY99 EPS of $0.90-$0.99, because defendants were prematurely recognizing revenue, in violation of GAAP and the Company's stated accounting policy, on contracts that would take years to complete. As a result, according to CW3 and CW24, project managers were told

that projects were "closed" for billing purposes, when the projects were actually far from completion. CW17, a financial analyst in Daou's San Diego headquarters, confirmed that, at the direction of McNeill, labor costs incurred after 100%, of the revenue on the project was recognized, were dumped into accounts receivable. After defendants finally reported Daou's disastrous 3Q98 results and revealed the financial impact of their accounting manipulations, Daou reported a FY98 loss of $0.33 per share. For FY99 Daou reported a loss of $0.52 per share, nowhere close to the projected earnings of $0.90-$0.92.

(l) CW2, a training manager based in Daou's headquarters reported that he was specifically told by both a senior-level network engineer and a Field Services project manager that defendants' revenue recognition on their projects was improper and was not based on Daou's stated POC accounting policy. As a result, according to CW2, both the network engineer and project manager left Daou after making their complaints about improper revenue recognition.

(m) Daou's work in progress account was primarily unbilled receivables, not hardware purchases for which no revenue had been recognized. CW4 and CW5 both confirm that Daou recognized a fixed percentage of revenue immediately upon ordering and receiving equipment for a project. CW13 and CW17, as detailed above, further confirmed that the work in progress account was comprised almost entirely of contract amounts Daou had recognized as revenue but for which it was not entitled to bill because little or no labor had yet taken place and the percentage of the project actually complete was lower than the percentage completion numbers defendants used to calculate reported revenue.

66. ***Defendants' knowledge of falsity***: Based on the reports of numerous witnesses, all of whom were former members of Daou's executive, Accounting or Field Services staff, defendants not only knew that the Company's reported financial results and earnings forecast were based on fraudulent accounting, but personally directed the violations of Daou's stated accounting policy and GAAP in order to artificially inflate revenues.

(a) Defendants G. Daou, D. Daou, McNeill and McGee personally directed Daou's recognition of revenue, financial reporting and public statements. Not only were these four defendants the top executives at Daou, but, according to CW23, a former executive assistant to one of the defendants, the Company was run "top to bottom" by G. Daou and D. Daou, with the assistance of McNeill and McGee. G. Daou and D. Daou, confirmed CW23, were particularly concerned with the Company's revenue recognition and exceeding the Company's projected revenue and earnings, and made the final decisions on POC accounting revenue to be recognized.

(b) CW13 confirmed that McNeill provided G. Daou and D. Daou with all raw POC and revenue recognition figures and, together with McGee, they personally determined what revenue Daou would publicly report. According to CW5, who reported to McNeill, McNeill, G. Daou and D. Daou paid particularly close attention to the POC and revenue recognition numbers, and were, with McGee, the only people at Daou who could determine how much revenue to publicly report. CW15 further confirmed that all decisions regarding recognition of revenue on Daou's contracts were made by McNeill, G. Daou and D. Daou.

(c) CW9, a regional Sales Vice President at Daou, confirmed that defendants G. Daou, D. Daou and McNeill not only made the decision on how much revenue to recognize without regard to any actual percentage of completion, but directed the practice of automatically recognizing revenue upon contract signing and ordering of equipment. Accordingly, from their own actions, these defendants knew their statements about Daou' accounting policy and revenue recognition were false and misleading when made.

(d) According to CW13, a former Daou Accounting Department Manager, in 1Q98 the Accounting Department, at McGee's direction, did a study of Daou's 100 largest contracts to identify the discrepancies between revenue recognized and actual billing. For nearly every single contract, the amount of revenue recognized greatly exceeded the amount that Daou could bill, indicating revenue recognized out of line with the percentage of the project actually completed. CW13 confirmed that a final report was provided to and discussed by G. Daou, D. Daou, McNeill, McGee and Neil Cassidy.

(e) CW18, a finance consultant at Daou, confirmed that during 1Q98 and 2Q98, and likely before, Neil Cassidy prepared a weekly update and forecast of actual versus projected revenue and results, highlighting the gap between revenue that could properly be recognized and the amount of revenue necessary to meet or exceed projections reported by analysts covering Daou. According to CW18, who worked with Cassidy, Cassidy's weekly report was distributed to Daou' senior management, D. Daou, G. Daou, McNeill and McGee.

(f) As identified by CW24 and described above, McNeill closely monitored that University of Chicago project and knew, in 1Q98, when revenue was recognized, that the strategic plan for implementation was not complete and Daou and the University had not agreed on terms for the project.

(g) CW17 was hired by Daou in late 1998 to assist in reconciling the Company's work in progress account with "unearned revenue" recognized in 1Q98 and 2Q98. According to CW17, McGee and Daou's senior management knew that revenue had been booked without relation to labor costs actually incurred or the percentage of a contract completed. CW17 confirmed, based on a review of Daou' 1Q98 and 2Q98 contracts, including the St. Mary's Hospital contract, that the POC figures had been "massaged" in order to report inflated revenue.

(h) Defendants knew that Daou had prematurely recognized 100% of the revenue on projects that were not near completion. Between 4Q97 and 1Q98, Daou's accounts receivable, which defendants publicly reported and were aware of increased $5.49 million. According to CW17, a former financial analyst at Daou, defendants knew that the accounts receivable balance at Daou represented labor costs incurred on a project ***after*** 100% of the revenue had been recognized under POC accounting. CW 13 confirmed that defendants' premature recognition of 100% of the revenue on contracts results in continuing labor costs being allocated to accounts receivable.

(i) All of the defendants knew how Daou's results were progressing in 1Q98 and knew that the reported revenue could only be achieved by manipulating

the Company's financial results. CW1, CW5, CW7, CW12, CW17 and CW21 all confirm that both actual labor costs incurred/completed and the estimates used to falsify Daou's revenue recognition were recorded under the direction of McNeill and distributed to G. Daou, D. Daou, McGee and, periodically to directors including Moragne. Each employee on a Daou project was provided with a workbook containing the template for an Excel spreadsheet. The spreadsheet (the job costing sheet) contained categories for hours worked, along with travel and non-billable time. For each time period (initially Sunday to Sunday, later changed to bi-weekly), the spreadsheet was provided to the project manager. The project manager would compile the billable time, make an estimate, based on the time and costs incurred to date, of the percent of the project that was complete and e-mail the information to Daou's project cost accounting staff in San Diego, who operated under COO McNeill. CW1, a project cost analyst, stated that the time and percentage of completion data was entered into the Company's ManFact accounting system. One or two days before the end of the month, Vice Presidents Ringwall and Mirabile would print out the ManFact reports containing actual labor and percent completion submitted by project managers, for the current month and quarter. According to CW1, CW3, CW4, CW7 and CW16, the ManFact data was compiled into a Monthly Project Report which was sent to G. Daou, D. Daou, McGee, and McNeill at the close of each month and quarter. The Monthly Project Report contained columns for customer name, project number, contract amounts (total revenue dollars), amount of revenue recognized in the six preceding months (identified by month), revenue to be recognized in the current month, and a 12-month forecast of revenue available to be recognized (identified by

month). Based on the comprehensive Monthly Project Report, G. Daou, D. Daou, McNeill and McGee, would adjust upward the percent completion for projects. According to CW1, who assisted in preparing the Monthly Project Report, after senior management's (G. Daou, D. Daou, McNeill, McGee) initial review of percentage of completion estimates, he would be directed by Ringwall or Mirabile to make manual adjustments in the ManFact system to increase the percentage of completion estimates submitted by project managers.

(j) CW1 further confirmed that Vice President Neil Cassidy and Project Analyst Wayne Walker would make jokes about the inflation of revenue recognition figures after defendants' review of the Monthly Project Report. Likewise, CW3, CW9 and CW27 confirmed that G. Daou, D. Daou and McNeill monitored the actual and reported progress on POC contracts and it was generally believed within the Company that they were improperly recognizing revenue without regard to the actual status of ongoing projects.

(k) CW9 confirmed G. Daou and D. Daou were active, day-to-day managers of the Company and routinely met with McNeill and McGee. G. Daou maintained his own project accounts, including Western Tennessee Healthcare, Mercy Health Services and the Stanford Medical Center. D. Daou oversaw mergers and acquisitions, using 6.6 million shares of Daou's artificially inflated stock to acquire 11 companies during the Class Period. CW4 further confirms that G. Daou, D. Daou and McNeill ran the day-to-day Field Services and Sales operations and McGee ran the Accounting Department.

(l) During the conference call and subsequent conversations with analysts and money and portfolio managers, defendants G. Daou, D. Daou, McGee and McNeill presented themselves as the persons at Daou most knowledgeable about the Company's reported revenue, earnings expectations, financial results and business. CW14, a former analyst who covered Daou, confirmed that these defendants, and in particular McGee, presented themselves as knowledgeable about all aspects of the Company's finances, including earnings and revenue recognized under POC accounting.

(m) D. Daou and McGee signed the report on Form 10-Q for 1Q98 attesting to the information therein and their knowledge of and basis for representing that Daou recognized revenue in line with its stated policy and had 1Q98 revenue of $18.1 million.

67. ***Defendants' false and misleading statements about Daou's 2Q98 accounting and financial reports:***

(a) On June 18, 1998, H&Q issued a report on Daou written after discussions with defendants G. Daou, D. Daou and McGee, which was based on and repeated information provided by them. The report stated:

> Following our meeting yesterday at the company, ***we received incremental news that the June quarter continues to be strong: we expect DAOU to meet or possibly exceed our June quarter estimate of $0.12 on revenue of $19.9 million.***

Firm	Date	1998 EPS	1999 EPS	Rating	Analyst
Hambrecht & Quist	4/27/98	$0.62	$0.90	Strong Buy	D. Godsey
Cowen & Co.	4/24/98	$0.55	$0.90	Buy	S. Tyagi
Legg Mason	4/24/98	$0.62	$0.92	Buy	J. Ackerman
Loewenbaum & Co.	4/24/98	$0.63	$0.95	Strong Buy	M. McEnroe
Adams, Harkness & Hill	4/24/98	$0.62	$0.92	Buy	C. Trafton
BT. Alex. Brown	4/24/98	$0.62	$0.90	Strong Buy	A. Gallo
BancAmerica Robertson Stephens	4/24/98	$0.62	$0.92	Buy	M. Samols

> ***We expect both nominal accounts receivable dollars, the WIP account, and DSOs to decline in Q2.*** As such, we expect cash flow to be moving toward break-even during the quarter.

The report reiterated H&Q's strong buy recommendation.

(b) On July 29, 1998, through the *Business Wire*, the Company announced ***record results for the second quarter and first half of 1998***, reporting, for ***Q2 1998, revenues of $28,043,000***, operating income of $1,453,000, accounts receivable of $19,978,000 and contracts work in progress of $22,329,000:

> For the quarter, ***DAOU reported revenues of $28 million, up 89% over the second-quarter 1997 revenues*** of $14.8 million. Net income for the second quarter of 1998 was $2.2 million, or $0.12 per share (prior to one-time merger costs of $2.9 million or $0.16 per), compared to net income of $0.5 million, or $0.03 per share, for the same period last year.
>
> * * *
>
> "We are very pleased with DAOU's performance during the first six months of 1998, and with our prospects as we enter the second half of the year," stated Georges Daou, chief executive officer of DAOU Systems. "We intend to add new customers and grow our market share as we broaden our service capabilities through internal development, acquisitions and expanded relationships with software vendors. The integration of our traditional infrastructure services and new healthcare IT consulting capabilities is progressing well, and the availability of our expanded service offerings is creating additional cross-selling opportunities for DAOU."

(c) Subsequent to the release of its 2Q98 results, Daou held a conference call for analysts, money and portfolio managers, institutional investors and large Daou shareholders to discuss Daou's results, its business and its prospects. During the call – and in follow-up conversations with analysts – G. Daou, D. Daou, McGee and McNeill stated:

- ***Daou's excellent 2Q results ($0.13 EPS before merger charge) was due to strong demand for its products*** and services and Daou's leveraging of its operating expenses.

- ***Daou was on track to report EPS of $0.62-$0.64 and $0.90-$0.97 in 1998 and 1999, respectively.***

(d) On July 30, 1998, securities analysts issued reports on Daou, which were based on and repeated information provided by G. Daou and D. Daou in the conference call and in follow-up conversations. These reports projected earnings for Daou and rated Daou as follows:

68. ***Reasons why defendants' 2Q98 statements were false and misleading:*** Daou's reported 2Q98 financial results and earnings forecasts, and defendants' statements attributing the "excellent Q2 results" to strong *demand* and new customers, were false and misleading when made. The following facts, corroborated by the accounts of at least 14 confidential witnesses, including accounting, engineering and executive personnel based in Daou's San Diego headquarters and at specific Company projects, confirm that, in truth, Daou's financial results and earnings forecasts were false and misleading and the result of defendants' improper revenue recognition in violation of Daou's stated accounting policy and GAAP.

(a) Defendants did not recognize revenue in accordance with POC accounting requirements or Daou's stated accounting policy. POC accounting and GAAP require that revenue not be recognized before it is earned and that all revenue recognized be based on the accurate measure of the labor costs to date compared to the total estimated labor costs for the project. According to CW5, a former engineer and assistant to one of Daou's Field Services executives, revenue was recognized on Daou's contracts without regard to actual labor costs incurred or projected. CW5, who dealt with accounting for ongoing contracts under defendant McNeill, confirmed that defendants would automatically record 20% of the revenue from a contract upon contract signing, prior to any labor costs being incurred. Forty percent of the revenue from contracts was recognized immediately after any equipment was ordered, and 50%-60% of the revenue was recognized as soon as the equipment was "burned-in" (configured and tested). CW5 confirmed that this revenue was recognized without regard to labor costs incurred.

(b) CW28, a former senior network engineer and project manager, confirmed that a fixed amount of revenue was recognized on contracts immediately upon signing, and that the revenue reported by defendants did not reflect labor costs incurred compared to total estimated labor costs. Former Sales executive CW9 further confirmed the accuracy of CW5 and CW28's reports, and identified that during this period defendants would recognize a fixed percentage of revenue upon a contract signing and upon ordering equipment, even when no labor costs were incurred.

(c) 2Q98 revenue was artificially inflated to present the image of strong growth and boost Daou's stock price. CW8, a Field Services Engineer, and CW3, a senior Design Engineer, both confirmed that it was known throughout Daou at this time that G. Daou, D. Daou and McNeil were engaged in improper revenue recognition and that revenue on POC contracts was being recognized prematurely (before labor costs were incurred). According to CW3, CW5, CW9 and CW12, this premature and improper revenue recognition – violating GAAP and Daou's stated accounting policy – was not limited to one or two contracts, but was true for all or virtually all Daou projects.

(d) Had Daou reported revenue in line with the amount it was entitled to bill customers pursuant to its contracts, actually reflecting contract work done to date, revenue would have been $25.8 million, 8% less than publicly reported ($28.0 million). CW13, CW17, and CW27 confirmed that the dramatic growth in Daou's work in progress account, increasing $2.2 million from 1Q98 to 2Q98, was the result of defendants' premature recognition of revenue. The work in progress account was comprised almost entirely of contract amounts Daou had recognized

as revenue but for which it was not entitled to bill because little or no labor had yet taken place and the percentage of the project actually complete was lower than the percentage completion numbers defendants used to calculate reported revenue.

(e) The reported increase in revenue during 2Q98 was attributable to defendants' improper recognition of revenue, not "strong demand. At least 8% of Daou's publicly reported revenue for 2Q98 was the result of prematurely recognizing revenue without any basis in actual labor costs incurred or actual total estimated labor costs.

(f) According to CW24, in 1Q98 and into 2Q98 Daou recognized revenue on a $2,000,000 call center project with the University of Chicago, when no contract had been signed. According to CW24, McNeill closely monitored the University of Chicago project and knew that the strategic plan for implementing the project was not completed until April 1998 and, as of June 30, 1998 (2Q98), Daou and the University of Chicago still had not agreed on the terms of the project. Later in the project, when CW24 submitted a job costing sheet detailing labor costs incurred, she was told by Field Services department executives, operating under McNeill, that the project had been "closed" for billing purposes, even though the project was not close to completion.

(g) CW1, who received and entered POC data in the Company's ManFact accounting system, stated that in 1Q98 and 2Q98 Daou had recognized 100% of the revenue on the Company's St. Mary's Health Network project, but that Field Services continued to submit job costing sheets, because the project was not 100% complete. According to

CW1, approximately $4 million in labor costs were incurred after Daou had recognized 100% of the revenue from the St. Mary's Health Network contract.

(h) Defendants' statements about Daou's 2Q98 revenue were also false because in addition to the immediate recognition of revenue after a contract was signed or equipment was ordered (and at a time when little or no labor costs had been incurred), defendants manipulated the actual labor costs incurred and estimated total labor costs. According to CW12 and CW28, both Field Services Engineers, the estimates of total labor costs provided by senior managers at project sites were routinely ignored for revenue recognition purposes. The estimates of total labor hours used to calculate revenue by defendants G. Daou, D. Daou, McNeill and McGee was, according to CW12, grossly understated and did not reflect the opinions of the on-site managers. CW28 further confirms that, during this period, he was told by Field Services Vice President Mirabile, who worked at the direction of McNeill, what percent complete his projects were (for revenue recognition purposes) and that these figures did not reflect the actual labor completed or labor required to complete the projects. According to CW28, based on his firsthand knowledge from Daou projects, the actual percentage of completion numbers were adjusted upward by Daou's senior executives to boost reported revenue.

(i) Daou was not on track to achieve FY98 EPS of $0.62 $0.64 or FY99 EPS of $0.90-$0.97, because defendants were prematurely recognizing revenue, in violation of GAAP and the Company's stated accounting policy, on contracts that would take years to complete. As a result, according to CW3 and CW24, project managers were told that projects were "closed" for billing purposes, when the

projects were actually far from completion. CW17, a financial analyst in Daou's San Diego headquarters, confirmed that, at the direction of McNeill, labor costs incurred after 100% of the revenue was recognized were dumped into accounts receivable. After defendants finally reported Daou's disastrous 3Q98 results and revealed the financial impact of their accounting manipulations, Daou reported a FY98 loss of $0.33 per share. For FY99 Daou reported a loss of $0.52 per share, nowhere close to the projected earnings of $0.90-$0.92.

(j) CW2, a training manager based in Daou's headquarters reported that he was specifically told by both a senior-level network engineer and a Field Services project manager that defendants' revenue recognition on their projects was improper and was not based on Daou's stated POC accounting policy. As a result, according to CW2, both the network engineer and project manager left Daou after making their complaints about improper revenue recognition.

(k) Daou's work in progress account was primarily unbilled receivables, not hardware purchases for which no revenue had been recognized. CW4 and CW5 both confirm that Daou recognized a fixed percentage of revenue immediately upon ordering and receiving equipment for a project. CW13 and CW17, as detailed above, further confirmed that the work in progress account was comprised almost entirely of contract amounts Daou had recognized as revenue but for which it was not entitled to bill because little or no labor had yet taken place and the percentage of the project actually complete was lower than the percentage completion numbers defendants used to calculate reported revenue.

69. ***Defendants' knowledge of falsity***: Based on the reports of numerous witnesses, all of whom were former members of Daou's Executive, Accounting or Field Services staff, defendants not only knew that the Company's reported financial results and earnings forecast were based on fraudulent accounting, but personally directed the violations of GAAP in order to artificially inflate revenues.

(a) Defendants G. Daou, D. Daou, McNeill and McGee personally directed Daou's recognition of revenue, financial reporting and public statements. Not only were these four defendants the top executives at Daou, but, according to CW23, a former executive assistant to one of the defendants, the Company was run "top to bottom" by G. Daou and D. Daou, with the assistance of McNeill and McGee. G. Daou and D. Daou, confirmed CW23, were particularly concerned with the Company's revenue recognition and exceeding the Company's projected revenue and earnings, and made the final decisions on POC accounting revenue to be recognized.

(b) CW13 confirmed that McNeill provided G. Daou and D. Daou with all raw POC and revenue recognition figures and, together with McGee, they personally determined what revenue Daou would publicly report. According to CW9, who reported to McNeill, McNeill, G. Daou and D. Daou paid particularly close attention to the POC and revenue recognition numbers, and were, with McGee, the only people at Daou who could determine how much revenue to publicly report. CW15 further confirmed that all decisions regarding recognition of revenue on Daou's contracts were made by McNeill, G. Daou and D. Daou.

(c) CW9, a regional Sales Vice President at Daou, confirmed that defendants G. Daou, D. Daou and McNeill not only made the decision on how much revenue to recognize without regard to any actual percentage of completion, but directed the practice of automatically recognizing revenue upon contract signing and ordering of equipment. Accordingly, from their own actions, these defendants knew their statements about Daou' accounting policy and revenue recognition were false and misleading when made.

(d) CW19, a former Chief Information Officer with a large Midwestern health services provider, confirmed that in 2Q98 he was personally contacted by G. Daou in an effort to get a contract signed for a project in Michigan and that G. Daou desperately told CW19 that Daou "needed the business." The contract was eventually awarded to one of Daou's competitors.

(e) According to CW13, a former Daou Accounting Department Manager, in 1Q98 the Accounting Department, at McGee's direction, did a study of Daou's 100 largest contracts to identify the discrepancies between revenue recognized and actual billing. For nearly every single contract, the amount of revenue recognized greatly exceeded the amount that Daou could bill, indicating revenue recognized out of line with the percentage of the project actually completed. CW13 confirmed that the final report was provided to and discussed by G. Daou, D. Daou, McNeill, McGee and Neil Cassidy.

(f) CW18, a finance consultant at Daou, confirmed that during 1Q98 and 2Q98, and likely before, Neil Cassidy prepared a weekly update and forecast of actual versus projected revenue and results, highlighting the gap

between revenue that could properly be recognized and the amount of revenue necessary to meet or exceed projections reported by analysts covering Daou. According to CW18, who worked with Cassidy, Cassidy's weekly report was distributed to Daou' senior management, D. Daou, G. Daou, McNeill and McGee.

(g) As identified by CW24 and described above, McNeill closely monitored the University of Chicago project and knew, in 2Q98, when revenue was recognized, that the strategic plan for implementation was not complete and Daou and the University had not agreed on terms for the project.

(h) CW17 was hired by Daou in late 1998 to assist in reconciling the Company's work in progress account with "unearned revenue" recognized in 1Q98 and 2Q98. According to CW17, McGee and Daou's senior management knew that revenue had been booked without relation to labor costs actually incurred or the percentage of a contract completed. CW17 confirmed, based on a review of Daou' 1Q98 and 2Q98 contracts, including the St. Mary's Hospital contract, that the POC figures had been "massaged" in order to report inflated revenue.

(i) Defendants knew that Daou had prematurely recognized 100% of the revenue on projects that were not near completion. Between 1Q98 and 2Q98, Daou's accounts receivable which defendants publicly reported and were aware of, increased $3.43 million. According to CW17, a former financial analyst at Daou, defendants knew that the accounts receivable balance at Daou represented labor costs incurred on a project *after* 100% of the revenue had been recognized under POC accounting. CW13 confirmed that defendants' premature recognition of

100% of the revenue on contracts resulted in continuing labor costs being allocated to accounts receivable.

(j) All of the defendants knew how Daou's results were progressing in 2Q98 and knew that the reported revenue could only be achieved by manipulating the Company's financial results. CW1, CW7, CW9, CW12, CW17 and CW21 all confirm that both actual labor costs incurred/completed and the estimates used to falsify Daou's revenue recognition were recorded under the direction of McNeill and distributed to G. Daou, D. Daou, McGee and periodically to directors, including Moragne. Each employee on a Daou project was provided with a workbook containing the template for an Excel spreadsheet. The spreadsheet (the job costing sheet) contained categories for hours worked, along with travel and non-billable time. For each time period (initially Sunday to Sunday, later changed to bi-weekly), the spreadsheet was provided to the project manager. The project manager would compile the billable time, make an estimate, based on the time and costs incurred to date, of the percent of the project that was complete and e-mail the information to Daou's project cost accounting staff in San Diego, who operated under COO McNeill. CW1, a project cost analyst, stated that the time and percentage of completion data was entered into the Company's ManFact accounting system. One or two days before the end of the month, Vice Presidents Ringwall and Mirabile would print out the ManFact reports containing actual labor and percent completion submitted by project managers, for the current month and quarter. According to CW1, CW3, CW4 CW7 and CW16, the ManFact data was compiled into a Monthly Project Report which was sent to G. Daou, D. Daou, McGee, and McNeill. The Monthly Project Report contained

columns for customer name, project number, contract amounts (total revenue dollars), amount of revenue recognized in the six preceding months (identified by month), revenue to be recognized in the current month, and a 12-month forecast of revenue available to be recognized (identified by month). Based on the comprehensive Monthly Project Report, G. Daou, D. Daou, McNeill and McGee would adjust upward the percent completion for projects. According to CW1, who assisted in preparing the Monthly Project Report, after senior management's (G. Daou, D. Daou, McNeill, McGee) initial review of percentage of completion estimates, he would be directed by RingwalI or Mirabile to make manual adjustments in the ManFact system to increase the percentage of completion estimates submitted by project managers.

(k) CW1 further confirmed that Vide [sic] President Neil Cassidy and Project Analyst Wayne Walker would make jokes about the inflation of revenue recognition figures after defendants' review of the Monthly Project Report. Likewise, CW3, CW9 and CW27 confirmed that G. Daou, D. Daou and McNeill monitored the actual and reported progress on POC contracts and it was generally believed within the Company that they were improperly recognizing revenue without regard to the actual status of ongoing projects.

(l) CW9 confirmed G. Daou and D. Daou were active, day-to-day managers of the Company and routinely met with McNeill and McGee. G. Daou maintained his own project accounts, including Western Tennessee Healthcare, Mercy Health Services and the Stanford Medical Center. D. Daou oversaw mergers and acquisitions, using 6.6 million shares of Daou's artificially inflated stock to acquire 11 companies during the Class

Firm	Date	1998 EPS	1999 EPS	Rating	Analyst
Loewenbaum & Co.	7/30/98	$0.64	$0.97	Strong Buy	C. Kislin
BancAmerica Robertson Stephens	7/30/98	$0.66	$0.94	Buy	M. Samols
Hambrecht & Quist	7/30/98	$0.67	$0.90	Strong Buy	D. Godsey
Adams, Harkness & Hill	7/30/98	$0.65	$0.97	Buy	C. Trafton
SG. Cowen Securities	7/30/98	$0.50	$0.80	Buy	S. Tyagi

Period. CW4 further confirms that G. Daou, D. Daou and McNeill ran the day-to-day Field Services and Sales operations and McGee ran the Accounting Department.

(m) During the conference call and subsequent conversations with analysts and money and portfolio managers, defendants G. Daou, D. Daou, McGee and McNeill presented themselves as the persons at Daou most knowledgeable about the Company's reported revenue, earnings expectations, financial results and business. CW14, a former analyst who covered Daou, confirmed that these defendants, and in particular McGee, presented themselves as knowledgeable about all aspects of the Company's finances, including earnings and revenue recognized under POC accounting.

70. In June 1998, with Daou's stock trading at artificially inflated prices as a result of defendants' false and misleading statements, defendants, led by D. Daou, acquired seven independent companies – Technology Management, Inc., International HealthCare Systems, Inc., Resources in HealthCare Innovations, Grand Isle Consulting, Inc., Healthcare Transition Resources, Inc., Innovative Systems Solutions, Inc. and Ultitech Resources Group, Inc. – in exchange for 4.23 million shares of stock valued at $88,281,360. The same acquisitions, if done after the Class Period when Daou's stock traded at an average of $5.24 a share, would have required 19.6 million shares.

71. ***Defendants' false and misleading statements about Daou's employee hiring and retention and the nonexistent "Daou University"***: Daou's ability to succeed and prosper as a corporate developer, installer and operator of healthcare network systems was dependent on well-trained and technologically-astute engineers and field

operators, as well as a knowledgeable sales staff. By 1997, the nationwide pool of highly trained and educated employees was drying up and technology companies, particularly in California, were being impaired by insufficient employee hiring and retention. Thus, throughout the Class Period, securities analysts and the market were particularly concerned about Daou's ability to hire, train and retain the qualified engineers and employees necessary to complete networking contracts and attract new business. Despite serious employee issues at Daou which dramatically impacted the Company's business, defendants made the following false and misleading statements during the Class Period:

(a) On April 29, 1997, Alex. Brown issued a "booster shot" research report on Daou, based on information received from the Individual Defendants, rating the Company's shares a "strong buy," in an attempt to boost Daou's stock price after it fell below its IPO price of $9 per share. Based on information from defendants, the report stated: "DAOU has been ***especially successful in bringing on very experienced hires.***" The report repeated that "***[Daou] attributes its success in this area to its state-of-the-art training policies*** . . . and competitive compensation plan."

(b) On July 16, 1997, subsequent to the release of its 2Q97 results, Daou held a conference call for analysts, money and portfolio managers, institutional investors and large shareholders to discuss Daou's 2Q results, its business and its prospects. During the call, and in follow-up conversations with analysts, G. Daou, D. Daou, McGee and McNeill stated:

- Daou was ***successfully retaining employees*** and hiring new engineers and was ***more than adequately staffed*** to support an expanding number of new customers.

- Daou's ***new sales-force hires were highly experienced*** and were adapting well.

(c) On October 15, 1997, subsequent to the release of its 3Q97 results, Daou held a conference call for analysts, money and portfolio managers, institutional investors and large shareholders to discuss Daou's 3Q results, its business and its prospects. During the call; and in follow-up conversations with analysts, G. Daou, D. Daou, McGee and McNeill stated:

- Daou was ***not having problems with employee turnover or attrition of engineers.***

(d) On January 21, 1998, subsequent to the release of its 4Q and FY97 results, Daou held a conference call for analysts, money and portfolio managers, institutional investors and large shareholders to discuss Daou's 4Q and FY97 results, its business and its prospects. During the call, and in follow-up conversations with analysts – G. Daou, D. Daou, McGee and McNeill stated:

- Daou had 340 employees and ***headcount was expected to grow as employee turnover continued to be low*** and Daou was attracting employees from its competitors.

(e) In May 1998, following the filing of the Company's 1Q98 Form 10-Q, defendants D. Daou and McGee made presentations at an Alex. Brown technology conference. During a "breakout" session, in response to a question about employee training, D. Daou and McGee stated that ***Daou University was a vibrant learning facility***

in San Diego where Daou employees were taught new technical skills and became certified in new computer languages and programs. D. Daou and McGee explained that Daou had an ongoing program with the local universities in San Diego whereby Daou brought in college students to "Daou University" in order to teach them systems and networking. McGee commented that many college students in San Diego would love to work for Daou and Daou University was creating a great pool of new recruits through the Company's alliance with San Diego colleges.

(f) On March 20, 1998, H&Q analyst D. Godsey visited Daou headquarters and met with Daou management, including G. Daou, D. Daou and McGee. During the visit, defendants told Godsey that Daou's professional retention rate was 90%+. On March 23, 1998, H&Q issued a report on Daou written by Godsey which repeated defendants' statement that Daou maintained a 90%+ professional retention rate.

(g) On July 29, 1998, subsequent to the release of its 2Q98 results, Daou held a conference call for analysts, money and portfolio managers, institutional investors and large shareholders to discuss Daou's 2Q results, its business and its prospects. During the call, and in follow-up conversations with analysts – G. Daou, D. Daou, McGee and McNeill stated:

- ***Daou's employee turnover remained very low*** and ***attrition within the technical ranks of employees was only 6.8%.***

72. As a result of these false and misleading statements, Daou's stock price was artificially inflated throughout the Class Period.

73. ***Reasons why defendants statements about Daou's employee hiring and retention and "Daou University" were false and misleading:*** Defendants' statements about "success" in hiring and retaining experienced employees, low employee turnover and "Daou University" were false and misleading when made. The following facts, corroborated by at least six confidential witnesses, including human resources, engineering and, executive personnel based in Daou's San Diego headquarters and at specific Company projects confirm that Daou was suffering from employee turnover exceeding 40% and could not attract appropriately trained personnel and that "Daou University" did not exist.

(a) According to CW2, a Technical Training Manager at Daou during the Class Period, Daou's public statements about its employee hiring, retention and training were false. Employee turnover, especially among the Field Services engineers, exceeded 40%. Moreover, according to CW2, no funding was provided for employee training. As a result, personnel were sent to projects without the qualifications to operate Daou's network systems. CW19 confirmed that, for example, in 1Q97, Daou sent a "PC Technician" and a "Sr. Engineer" to Mercy Health Services to work full-time in the customer's networking department. Neither person had any technical or engineering training and they could not even operate Windows 95. The Daou "specialists" had to attend Mercy's Windows 95 training with Mercy's own employees.

(b) CW8 and CW26, both Field Service Engineers, confirmed that employee turnover at Daou was at least 30%-40% and that Daou could not retain qualified engineers because of low pay, no training and excessive

travel. As a result unqualified personnel were sent to job sites and Daou could not adequately staff its projects.

(c) According to CW2 and CW3, in 1Q98 Vice President of Human Resources Dan Porter admitted internally to them and others that Daou's employee turnover rate exceeded 40%, not 6.8%, and that Daou could not adequately address staffing problems at the Company's projects.

(d) In addition to a lack of funding for in-house training, no former company employee, including those who worked with Daou's executives and in human resources, had ever heard of "Daou University" and no former employee believed that "Daou University" existed. CW2 confirmed that Daou had no in-house training program whatsoever and, according to CW21, the Company was hiring, among others, untrained mechanics and cable pullers as computer technicians, not college graduates.

74. ***Defendants' knowledge of falsity***: Based on the reports of numerous witnesses, all of whom were former members of Daou's Human Resources, Field Services or executive staff, defendants knew throughout the Class Period that Daou was suffering from employee retention and hiring problems and defendants had no basis to believe that Daou University existed. According to CW2 and CW3, Daou's problems with hiring and retaining qualified employees was well-known throughout the Company. CW19 confirmed that, with regard to staffing problems at Daou's Mercy Health Services project, he personally spoke with G. Daou and noted that the staffing being provided was insufficient and untrained. CW2 confirmed that Daou's senior management, including

G. Daou, D. Daou and McNeill, set the budget, or lack thereof; for in-house training and knew it was not adequate. CW3, CW8 and CW19 further confirmed that Dan Porter, the Vice President of Human Resources who acknowledged at Company meetings that turnover was exceeding 40%, met with G. Daou, D. Daou, McNeill and McGee on a weekly basis to review Daou's business status, prospects and problems.

75. ***Defendants' false and misleading statements about Daou's customers, contracts and pipeline and backlog:***

(a) On April 21, 1997 subsequent to the release of its 1Q97 results, Daou held a conference call for analysts, money and portfolio managers, institutional investors and large shareholders to discuss Daou's results, its business and its prospects. During the call, and in follow-up conversations with analysts, G. Daou, D. Daou, McGee and McNeill stated:

- ***Daou had an extremely strong backlog of $63 million and pipeline of orders,*** which would lead to ***continued strong revenue and earnings growth in 1997 and 1998.***

- Daou saw ***significant increases in new business on all fronts*** and repeat business from existing clients with excellent visibility going forward.

(b) On April 29, 1997, Alex. Brown & Sons, Inc. ("Alex. Brown") issued a "booster shot" research report on Daou, based on information received from the Individual Defendants, rating the Company's shares a "strong buy," in an attempt to boost Daou's stock price after it fell below its IPO price of $9 per share. Based on information from defendants, the report stated: ***"DAOU benefits from an***

***extremely strong backlog and pipeline position.*"** By June 13, 1997, when Alex. Brown issued its next research report on Daou, reiterating its "strong buy" rating, Daou's stock price had increased to $13 per share, and Alex. Brown raised its 12-month price target for Daou stock from $11 to $16 per share.

(c) On October 15, 1997, subsequent to the release of its 3Q97 results, Daou held a conference call for analysts, money and portfolio managers, institutional investors and large shareholders to discuss Daou's results, its business and its prospects. During the call, and in follow-up conversations with analysts – G. Daou, D. Daou, McGee and McNeill stated:

- ***Backlog was now $26.7 million, up from $10 million in 1Q97 and $20 million in 2Q97,*** and visibility was excellent.

- Daou's ***order pipeline and acquisition pipeline remained healthy and would fuel future earnings growth.***

(d) On January 21, 1998, subsequent to the release of its 4Q and FY97 results, Daou held a conference call for analysts, money and portfolio managers, institutional investors and large shareholders to discuss Daou's 4Q and FY97 results, its business and its prospects. During the call, and in follow-up conversations with analysts, G. Daou, D. Daou, McGee and McNeill stated:

- Backlog had jumped to $42.9 million and the order pipeline provided ***tremendous visibility into 1998 and 1999 revenue and earnings growth, with 81% of expected 1998 revenue already booked.***

(e) On April 23, 1998, subsequent to the release of its 1Q98 results, Daou held a conference call for analysts,

money and portfolio managers, institutional investors and large Daou shareholders to discuss Daou's results, business and prospects. During the call, and in follow-up conversations with analysts, G. Daou, D. Daou, McGee and McNeill stated:

- ***Daou was successfully adding new customers and its momentum was increasing.***

- ***Backlog was strong*** with a total of $84 million in backlog, and the core pipeline reached $152 million.

(f) On July 29, 1998, subsequent to the release of its 2Q98 results, Daou held a conference call for analysts, money and portfolio managers, institutional investors and large shareholders to discuss Daou's 2Q results, its business and its prospects. During the call, and in follow-up conversations with analysts – G. Daou, D. Daou, McGee and McNeill stated:

- ***Backlog was strong,*** totaling $98.5 million with $56 million over the next 12 months and $34 million over the next six months and the core order pipeline stood at $182 million.

- ***Visibility of future earnings was outstanding.***

76. ***Reasons why defendants' statements about Daou's customers, contracts and pipeline and backlog were false and misleading:*** Defendants' repeated statements about Daou's "extremely strong backlog and pipeline position" and attributions of "outstanding" future demand, earnings and revenue to the Company's pipeline position were false and misleading when made. The following facts, corroborated by at least six confidential witnesses, including Accounting, Field Services and executive personnel based in Daou's San Diego headquarters and at specific Company

projects, confirm that Daou's backlog and pipeline claims were not based on any actual contractual demand and were highly speculative, at best.

(a) According to Sales Vice President CW9 and CW20, by 2Q97 Daou was suffering from a lack of new sales and contract signings. During this period, Daou's seven regional sales vice presidents were unable to meet the projected quarterly sales quota and there was little new business development. The pipeline figures, promoted to analysts as a measure of Daou's business expansion, were highly speculative and not indicative of existing demand for Daou's services. CW1 confirmed that defendants' statements were based on the monthly "Pipeline Report" prepared by Neil Cassidy at the direction of McNeill, which listed existing and prospective contracts, the potential sales revenue involved and the probability of closing the sale. The "revenue" listed in the report and provided to analysts and the market was, according to CW9, automatically set at 20% of a contract's total value if a Daou salesperson had even met with the prospective client to discuss a deal; 50% if Daou had submitted a deal proposal, 70% if Daou had submitted a formal bid on the deal, 90% if Daou "appeared to have won" but the deal was not formally closed and 100% when the sale was formerly closed. The pipeline figure, despite defendants' representations, did not actually reflect contracts Daou would actually get, and included millions of dollars on projects that Daou had little or no chance of actually doing.

(b) The likelihood of Daou getting repeat business from current customers was low. According to CW20, CW22 and CW24, Daou's primary customers, including Mercy Health Services, Huntington Memorial Hospital,

the University of Chicago and St. Agnes Health Center were all complaining in 1997 and early 1998 about overdue and overbudget projects and Daou's inability to provide adequate staffing. In the case of both Mercy Health Services and Huntington Memorial Hospital, Daou failed to provide the on-site engineers required under the terms of the contracts and, according to CW3, unqualified "technicians" were sent to most of Daou's ongoing projects because of the Company's high employee turnover.

77. ***Defendants' knowledge of falsity***: Based on the reports of numerous witnesses, all of whom were former members of Daou's Field Services or executive staff, defendants knew throughout the Class Period that Daou's vaunted backlog and pipeline figures were arbitrarily determined with no basis in fact and did not represent purported strong growth or momentum.

(a) According to CW1 and CW1, Daou's seven regional sales vice presidents held a weekly or biweekly conference call with McNeill to update McNeill on the status or outlook of prospective projects. Based on these calls and follow-up conversations with the regional vice presidents, McNeill directed Neil Cassidy to prepare a monthly Pipeline Report. The Pipeline Report contained the arbitrary determination of future business based on fixed percentages of proposed contracts' value. According to CW1 and CW17, the Pipeline Report was distributed, at the end of each calendar month, to G. Daou, D. Daou, McNeill and McGee. The arbitrary determination of "revenue" allocated to the pipeline was made by G. Daou, D. Daou, McNeill and McGee.

(b) CW9 further confirmed that after the distribution of the quarter-end Pipeline Report, Daou's sales

and field services vice presidents met in San Diego with D. Daou, G. Daou, McNeill, McGee, Ringwall and Dan Porter to discuss both actual and reported revenue, as well as the purported pipeline.

(c) During the conference call, and subsequent conversations with analysts and money and portfolio mangers, defendants D. Daou, G. Daou, McNeill and McGee presented themselves as the persons at Daou most knowledgeable about the Company's purported pipeline.

THE REVELATION OF ADVERSE FACTS

78. On August 13, 1998, the Company filed its report on Form 10-Q with the SEC signed by defendants D. Daou and McGee, and the impact of defendants' financial shenanigans began to leak out. In its Form 10-Q, the Company reported figures that were entirely different than what defendants had stated just two weeks earlier in Daou's July 29, 1998 press release and conference call to analysts. Although the Company had represented in its July 29, 1998 press release that earnings excluding merger charges were $0.12 and that its general and administrative expenses for the second quarter were $2.34 million and its merger expenses were $2.9 million, its Form 10-Q revealed a different story. According to its Form 10-Q, the Company's general and administrative expenses were actually $3.54 million while merger-related expenses were only $1.02 million, revealing that the Company's operating income expenses before merger was only $0.08, or 33% less than originally reported. Defendants had been aware of this information two weeks earlier when they reported the false figures to analysts and the investing public. Defendants failed to disclose the

actual figures to analysts to conceal the fact that Daou's operating earnings and margins were deteriorating as a result of prematurely and improperly recognizing revenue. Despite these changes, defendants again represented that "[t]hese financial statements reflect all adjustments, consisting of only normal recurring adjustments, which in the opinion of management are necessary to fairly present the financial position of [Daou] at June 30, 1998 and the results of operations for the three and six-month periods ended June 30, 1998 and 1997."

79. In response to these disclosures, analysts were outraged about being misled. As one analyst noted, "[when you say one thing on the conference call and report something different on the 10-Q, that raises concern. . . . ***You have got to question whether they are manufacturing earnings.***"

80. Not surprisingly, the market reacted dramatically to these discrepancies. On the day following the revelation, the Company's stock price fell $5.75 per share to $12.75 in heavy trading, but continued to trade at artificially inflated levels through the remainder of the Class Period due to defendants' continued false statements.

81. During the following weeks, amid negative rumors and speculation, defendants steadfastly maintained that Daou's financial statements were accurate and that its business fundamentals and momentum remained intact.

82. Finally, on October 28, 1998, Daou reported such extremely poor results for the 3Q98 that defendants' credibility was completely lost. Daou reported revenues of only $27.4 million, a loss of $3.1 million or $0.17 per share,

accounts receivable of $30.5 million and contract work in progress of $12.3 million. Operating margin was a negative 17.2%. Defendants blamed the poor results on delays in the signing of projects totaling approximately $42 million, $4 million of which was expected to be booked as revenue during Q3. Defendants disingenuously blamed these delays on negative publicity. In the conference call with analysts, defendants conceded the following points:

- Daou's general and administrative costs increased $2 million over the 2Q98 figure, which latter figure Daou claimed included a million dollars of one-time expenses, implying that the general and administrative cost figure effectively increased by $3 million sequentially.

- General and administrative costs, as a percentage of revenues, had swollen to 21% in 3Q98, compared with only 14% in 3Q97.

- Accounts receivable measured in days' sales outstanding ballooned to 105 days versus 71 days in 2Q98.

- Daou had to record $400,000 in additional accounts receivable reserves in 3Q98.

- Daou claimed to have reduced its contract work in progress account some 50% by accelerating billing milestones, thereby reducing unbilled receivables by some $10 million which flatly contradicted Daou's prior statements that unbilled receivables represented only $900,000 of contract work in progress.

83. As a result of these announcements, the market finally understood that it was all a big lie. Daou's stock dropped to as low as $3.25 on volume of 3.2 million shares,

more than a 90% decline from the Class Period high of $34.375.

84. Daou ultimately reported a 1998 ***loss*** of $0.33 per share versus Class Period estimates of earnings of $0.50-$0.67, and a FY99 ***loss*** of $0.52 per share versus Class Period estimates of $0.90-$0.97. In response to analyst outrage and this litigation, Daou also announced that it was moving its business practice away from fixed-price contracts to charging on a time and expense basis, in an attempt to make its business profitable. As the chart set forth below demonstrates, Daou has never recovered from defendants' fraud and, without artificially inflated revenue, has never come close to actually achieving the revenues reported during the Class Period.

CLASS ACTION ALLEGATIONS

85. Plaintiffs bring this action as a class action pursuant to Federal Rule of Civil Procedure 23(a) and (b)(3) on behalf of a class consisting of all persons who purchased or acquired shares of Daou common stock (the "Class") from February 13, 1997 through October 28, 1998, inclusive, and who were damaged thereby. Excluded from the Class are the defendants, officers and directors of the Company, members of their immediate families and their legal representatives, heirs, successors or assigns and any entity in which defendants have or had a controlling interest.

86. The members of the Class are so numerous that joinder of all members is impracticable. The disposition of their claims in a class action will provide substantial benefits to the parties and the Court. As of March 6, 1998, Daou had approximately 11,826,654 shares of common stock outstanding, owned by thousands of shareholders. Record owners and other members of the Class may be identified from records maintained by Daou or its transfer agent and may be notified of the pendency of this action by mail, using the form of notice similar to that customarily used in securities class actions.

87. Plaintiffs' claims are typical of the claims of the members of the Class as all members of the Class are similarly affected by defendants' wrongful conduct in violation of the federal law that is complained of herein.

88. Plaintiffs will fairly and adequately protect the interests of the members of the Class and has retained counsel competent and experienced in class and securities litigation.

89. There is a well-defined commonality of interest in the questions of law and fact involved in this case. The questions of law and fact common to the members of the Class which predominate over questions which may affect individual Class members include:

(a) Whether the federal securities laws were violated by defendants;

(b) Whether defendants omitted and/or misrepresented material facts;

(c) Whether defendants participated in and pursued the common course of conduct complained of herein, specifically, whether defendants misstated the financial results of the Company in public statements including press releases and filings with the SEC, in direct contravention of GAAP;

(d) Whether documents, press releases and other statements disseminated to the investing public and the Company's shareholders during the Class Period misrepresented and/or omitted material facts about the business, financial condition, and future business prospects of Daou;

(e) Whether defendants acted with scienter in knowingly or recklessly omitting and/or misrepresenting material facts regarding the financial state of the Company;

(f) Whether the market price of Daou common stock during the Class Period was artificially inflated due to the material misrepresentations and failure to correct the material misrepresentations complained of herein; and

(g) The extent of damages sustained by Class members and the appropriate measure of damages.

90. Plaintiffs will rely, in part, upon the presumption of reliance established by the fraud-on-the-market doctrine in that:

(a) Defendants made public misrepresentations or omitted material facts during the Class Period, as alleged herein;

(b) The misrepresentations and/or omissions were material;

(c) Daou's common stock was traded in an efficient market;

(d) The misrepresentations and/or omissions alleged tended to induce reasonable investors to misjudge the value of Daou shares; and

(e) Plaintiffs and members of the Class acquired their shares between the time defendants made the misrepresentations and/or omissions and the time the truth was revealed, without knowledge of the falsity of the misrepresentation.

91. Based upon the foregoing, plaintiffs and the other members of the Class are entitled to a presumption of reliance upon the integrity of the market for, at least, the purposes of class certification, as well as for ultimate proof of the claims on their merits. Similarly, plaintiffs and the members of the Class are entitled to a presumption of reliance with respect to the omissions alleged herein.

92. A class action is superior to all other available methods for the fair and efficient adjudication of this

controversy. Furthermore, as the damages suffered by individual Class members may be relatively small, the expense and burden of individual litigation makes it impossible for members of the Class to individually redress the wrongs done to them. There will be no difficulty in the management of this class action.

STATUTORY SAFE HARBOR

93. The statutory safe harbor provided for forward-looking statements under certain circumstances does not apply to any of the allegedly false forward-looking statements pleaded in this complaint because the statutory safe harbor does not apply to Daou's financial statements and because none of the particular oral forward-looking statements pleaded herein was identified as "forward-looking statements" when made. None of the written forward-looking statements made was identified as forward-looking statements. Nor was it stated as to either type of forward-looking statement that actual results "could differ materially from those projected." Nor did meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statements accompany those forward-looking statements. In any event, each of the forward-looking statements alleged herein was authorized by an executive officer of Daou, and was actually known by each of the Individual Defendants to be false when made.

FIRST CLAIM FOR RELIEF

For Violations of Section 10(b) of the Exchange Act and Rule 10b-5 Promulgated Thereunder Against All Defendants

94. Plaintiffs incorporate ¶¶1-93.

95. During the Class Period, defendants, and each of them, carried out a plan, scheme and course of conduct which was intended to and, throughout the Class Period, did: (i) deceive the investing public, including plaintiffs and the other Class members, as alleged herein; (ii) artificially inflate and maintain the market price of Daou securities; and (iii) cause plaintiffs and other members of the Class to purchase Daou securities at inflated prices. In furtherance of this unlawful scheme plan and course of conduct, defendants, and each of them, took the actions set forth herein.

96. Defendants (a) employed devices, schemes, and artifices to defraud; (b) made untrue statements of material fact and/or omitted to state material facts necessary to make the statements made not misleading; and (c) engaged in acts, practices, and a course of business which operated as a fraud and deceit upon the purchasers of the Company's stock in an effort to maintain artificially high market prices for Daou's securities in violation of §10(b) of the Exchange Act and Rule 10b-5.

97. The statements made by defendants during the Class Period were materially false and misleading because at the time they were made, defendants knew or recklessly ignored, but failed to disclose, the matters set forth herein.

98. In ignorance of the artificially inflated market prices of Daou's publicly traded securities, and relying

directly on defendants or indirectly on the false and misleading statements made by defendants, upon the integrity of the market in which the securities trade, on the integrity of the regulatory process and the truth of any representations made to appropriate agencies at the time of the public offering and/or on the absence of material adverse information that was known to defendants but not disclosed in public statements by defendants during the Class Period, plaintiffs and the other members of the Class acquired Daou securities during the Class Period at artificially high prices and were damaged thereby.

99. Had plaintiffs and the other members of the Class and the marketplace known the truth about the true financial condition and business prospects of Daou, which were not timely disclosed by defendants, plaintiffs and other members of the Class would not have purchased or otherwise acquired their Daou securities during the Class Period, or, if they had acquired such securities during the Class Period, they would not have done so at the artificially inflated prices which they paid. Hence, plaintiffs and the Class were damaged by defendants' violations of §10(b) and Rule 10b-5.

100. As a direct and proximate result of defendants' wrongful conduct, plaintiffs and the other members of the Class suffered damages in connection with their purchases of the Company's securities during the Class Period.

SECOND CLAIM FOR RELIEF

For Violation of Section 20(a) of the Exchange Act Against Defendants Daou, G. Daou, D. Daou, McGee and McNeill

101. Plaintiffs incorporate ¶¶1-100. Plaintiffs assert this claim against Daou, G. Daou, D. Daou, McGee and McNeill. These defendants acted as controlling persons of Daou within the meaning of §20 of the Exchange Act as alleged herein. By virtue of their executive and directorial positions, their knowledge and involvement in the day-to-day business of Daou, including its financial reporting, their stock ownership, and their power and ability to make public statements on behalf of Daou to shareholders, potential investors and the media, defendants had the power and ability to control the actions of Daou.

102. By reasons of wrongful conduct, defendants are liable pursuant to §20(a) of the Exchange Act. As a direct and proximate result of defendants' wrongful conduct, plaintiffs and the other members of the Class suffered damages in connection with their purchases of the Company's securities during the Class Period.

THIRD CLAIM FOR RELIEF

For Violation of Section 11 of the Securities Act Against Defendants Daou, G. Daou, D. Daou, McGee and Moragne

103. Plaintiffs incorporate ¶¶1-102.

104. This Claim is brought pursuant to §11 of the Securities Act, 15 U.S.C. §77k, by plaintiffs on behalf of that portion of the Class that acquired Daou common stock issued pursuant to the Registration Statement effective

February 13, 1997, against defendants Daou, G. Daou, D. Daou McGee and Moragne.

105. The Registration Statement issued by Daou was inaccurate and misleading, contained untrue statements of material facts, omitted to state other facts necessary to make the statements made not misleading and failed to adequately disclose material facts, as is described above.

106. Daou is the issued of the stock sold via the Registration Statement. As issuer of the shares, Daou is strictly liable to plaintiffs and that portion of the Class that purchased shares issued pursuant to this Registration Statement, for the material misstatements and omissions therein.

107. The Individual Defendants named in this Claim each signed the Registration Statement. None of the defendants named herein made a reasonable investigation or possesses reasonable grounds for the belief that the statements contained in the Registration Statement were true, did not omit any material fact and were not misleading.

108. Each of the defendants named in this Claim issued, caused to be issued and participated in the issuance of materially false and misleading written statements to the investing public which were contained in the Registration Statement, which misrepresented or failed to disclose, *inter alia*, the facts set forth above. As a direct and proximate result of defendants' acts and omissions in violation of the Securities Act, the market price of Daou stock was artificially inflated, and plaintiffs and other Class members suffered substantial damage in connection with their acquisition of Daou common stock issued pursuant to the Registration Statement. By reasons of the

conduct herein alleged, each defendant named in this Claim violated, and/or controlled a person who violated, §11 of the Securities Act.

109. At the times they acquired Daou shares, plaintiffs and other members of the Class were without knowledge of the facts concerning the false or misleading statements or omissions alleged herein. Less than one year elapsed from the time that plaintiffs discovered or reasonably could have discovered the facts upon which this Complaint is based to the time of the filing of this action. Less than three years have elapsed from the time that the securities upon which this Claim is brought were *bona fide* offered to the public, to the time of the filing of this action.

FOURTH CLAIM FOR RELIEF

For Violations of Section 12(a)(2) of the Securities Act Against Defendants Daou, G. Daou, D. Daou, McGee and Moragne

110. Plaintiffs incorporate ¶¶1-109..

111. This Claim is brought pursuant to §12(a)(2) of the Securities Act, 15 U.S.C. §771(a)(2) by plaintiffs on behalf of that portion of the Class that acquired Daou common stock issue pursuant to the Registration Statement effective February 13, 1997 against defendants Daou, G. Daou, D. Daou, McGee and Moragne.

112. Defendants Daou, G. Daou, D. Daou, McGee and Moragne were solicitors of sales of the shares offered and sold in connection with the February 13, 1997 Registration Statement and Prospectus.

113. The actions of solicitation taken by the defendants named in this Claim included participation in the preparation and in the dissemination of the false and misleading Prospectus. The written and oral communications made in connection with the Prospectus contained untrue statements of material facts, omitted to state other facts necessary to make the statements made not misleading and failed to disclose material facts.

114. Daou offered for sale the shares acquired by plaintiffs and other Class members.

115. Each defendant named in this Claim solicited and/or was a substantial factor in the acquisition of Daou common stock by these members of the Class. But for the participation by these defendants, including the solicitation by these defendants as set forth herein, the wrongful conduct alleged herein could not and would not have been accomplished. The defendants named herein participated in the acts detailed herein as follows:

(a) They actively and jointly drafted, revised, and approved the Prospectus and other written materials by which Daou shares were offered to plaintiffs and members of the Class. These written materials were "selling documents," calculated by these defendants to create interest in Daou common stock and were distributed by defendants for that purpose; and

(b) They finalized the Registration Statement and Prospectus and caused it to become effective.

116. The defendants named in this Claim were obligated to make a reasonable and diligent investigation of the written and oral statements made in the Prospectus, to insure that such statement were true and that there

was no omission to state a material fact required to be stated in order to make the statements contained therein not misleading.

117. Plaintiffs and other members of the Class acquired Daou shares issued pursuant to the defective Registration Statement and Prospectus, and were damaged thereby. These Class members did not know, or in the exercise of reasonable diligence could not have known, of the untruths and omissions contained in the Registration Statement and Prospectus.

118. By reason of the conduct alleged herein, these defendants violated, and/or controlled a person who violated, §12(a)(2) of the Securities Act. As a direct and proximate result of these violations of §12(a)(2), plaintiffs and the other members of the Class sustained substantial damage in connection with the acquisition of Daou stock.

119. Less than one year has elapsed from the time that plaintiffs discovered or reasonably could have discovered the facts upon which this complaint is based to the time of the filing of this action. Less than three years has elapsed from the time that the securities upon which this Claim is brought were sold to the public to the time of the filing of this action.

FIFTH CLAIM FOR RELIEF

For Violation of Section 15 of the Securities Act Against Defendants Daou, G. Daou, D. Daou and McGee

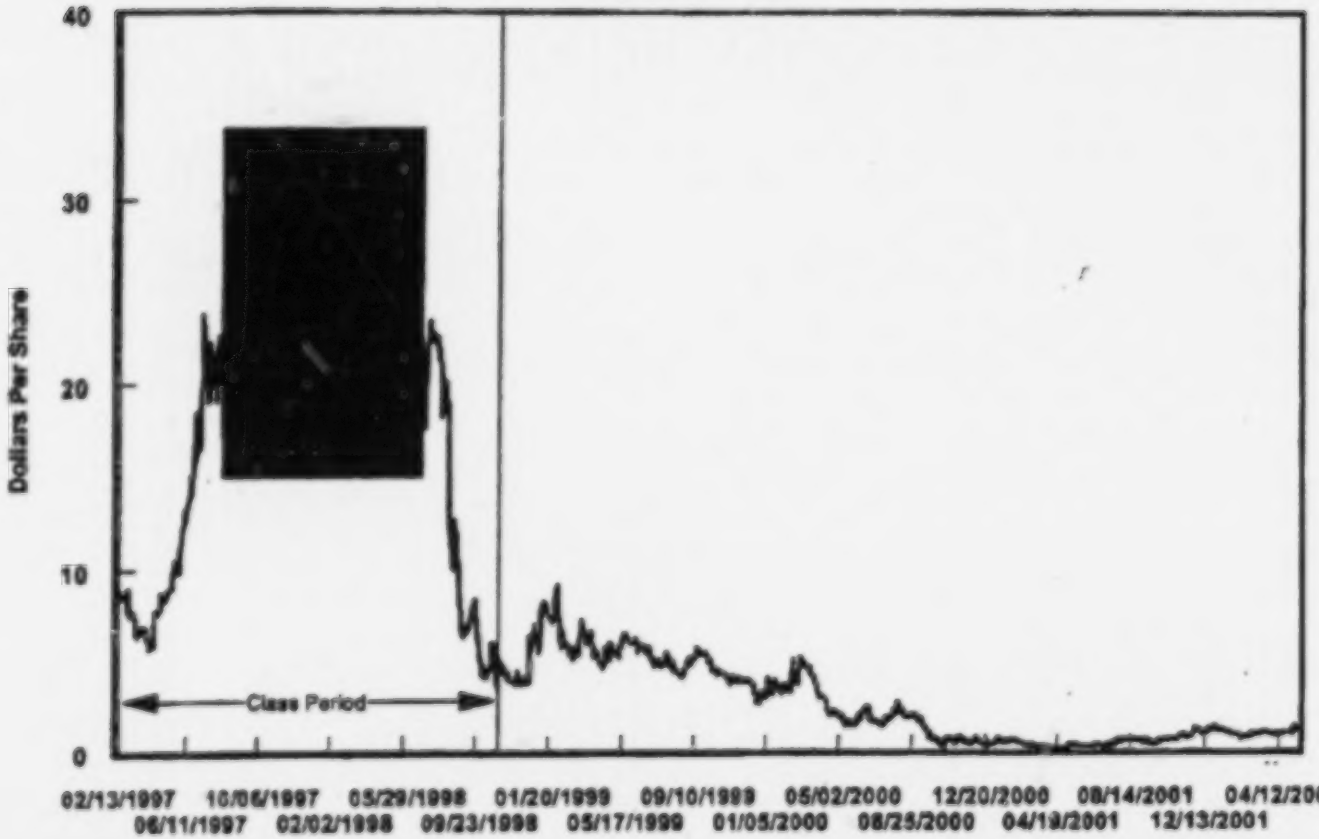
120. Plaintiffs Incorporate ¶¶1-119.

121. Plaintiffs assert this Claim against G. Daou, D. Daou and McGee. These defendants acted as controlling

Daou Systems, Inc.

February 13, 1997 - May 14, 2002

Daily Share Prices



persons of Daou within the meaning of §15 of the Securities Act as alleged herein. By virtue of their executive and directorial positions, their knowledge and involvement in the business of Daou, their stock ownership, and their power and ability to make public statements on behalf of Daou to shareholders, potential investors and the media, defendants had the power and ability to control the actions of Daou, and exercised the same, to cause Daou to engage in the violations of law complained of herein. These defendants are therefore liable under §15 of the Securities Act.

122. Daou controlled each of the Individual Defendants named in this Claim and is liable for their acts under §15 of the Securities Act.

PRAYER FOR RELIEF

WHEREFORE, plaintiffs pray for judgment as follows:

1. Declaring this action to be a proper class action pursuant to Rule 23(a) and (b)(3) of the Federal Rules of Civil Procedure on behalf of the Class defined herein;

2. Awarding plaintiffs and the members of the Class compensatory damages, including rescission where applicable;

3. Awarding plaintiffs and the members of the Class pre-judgment and post-judgment interest, as well as reasonable attorneys' fees, expert witness fees, and other costs;

4. Awarding extraordinary, equitable and/or injunctive relief as permitted by law, equity and federal statutory provisions sued hereunder, pursuant to Rules 64, 65 and any appropriate state law remedies; and

5. Awarding such other relief as this Court may deem just and proper.

JURY DEMAND

Plaintiffs demand a trial by jury.

DATED: May 16, 2002

MILBERG WEISS BERSHAD HYNES & LERACH LLP
WILLIAM S. LERACH
JAN M. ADLER
TOR GRONBORG
KAREN A. BATCHER

/s/ Jan M. Adler
JAN M. ADLER

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Telephone: 619/231-1058

Lead Counsel for Plaintiffs

APPENDIX A

Lead Plaintiff	Date	Shares Purchased	Share Price	Total Loss
De Kruyff, Patrick	06/25/98	2000	$21.000	
		2000		($27,848.00)
Ford, Rod	11/12/97	250	$16.50	
Ford, Rod	03/03/98	500	$26.50	
Ford, Rod	03/18/98	500	$19.00	
Ford, Rod	03/23/98	250	$19.00	
		1500		($21,011.00)

Hagman, Thomas V.	07/28/98	1000	$20.00	
Hagman, Thomas V.	08/14/98	1000	$14.88	
		2000		($20,723.00)
Krabbenoft, Eugene	03/18/98	1000	$26.75	
Krabbenoft, Eugene	03/30/98	400	$18.75	
Krabbenoft, Eugene	04/30/98	1000	$18.75	
Krabbenoft, Eugene	05/04/98	1000	$18.50	
		3400		($47,441.60)
Rabin, Paul	02/13/97	3000	$9.375	
Rabin, Paul				
		3000		($1,500.00)
Sparling, Greg	01/22/98	1,000	$24.375	
Sparling, Greg	01/29/98	1,000	$22.500	
Sparling, Greg	03/19/98	1,000	$20.375	
Sparling, Greg	03/19/98	2,000	$21.000	
Sparling, Greg	04/29/98	1,000	$18.125	
Sparling, Greg	05/05/98	1,000	$17.250	
Sparling, Greg	05/07/98	4,000	$16.500	
Sparling, Greg	05/22/98	1,500	$18.000	
Sparling, Greg	05/22/98	2,000	$17.813	
Sparling, Greg	05/22/98	1,500	$17.875	
Sparling, Greg	05/27/98	3,000	$16.438	
Sparling, Greg	06/09/98	1,000	$15.625	
Sparling, Greg	06/10/98	1,000	$15.750	
Sparling, Greg	06/11/98	1,000	$15.250	
Sparling, Greg	06/12/98	1,000	$14.000	

Sparling, Greg	07/01/98	1,500	$20.875	
Sparling, Greg	07/01/98	1,500	$21.000	
Sparling, Greg	07/07/98	3,000	$18.375	
Sparling, Greg	07/30/98	1,000	$20.750	
Sparling, Greg	08/03/98	3,000	$18.500	
Sparling, Greg	08/04/98	3,000	$17.625	
Sparling, Greg	08/06/98	1,000	$18.750	
Sparling, Greg	08/06/98	1,000	$18.500	
Sparling, Greg	08/10/98	2,000	$18.938	
Sparling, Greg	08/12/98	2,000	$18.500	
Sparling, Greg	08/13/98	500	$18.500	
Sparling, Greg	08/14/98	3,000	$14.875	
Sparling, Greg	08/14/98	2,000	$13.500	
		47,500		($48,840.50)
Toribio, Richard	09/23/97	500	$34.00	
Toribio, Richard	09/26/97	500	$36.00	
Toribio, Richard	03/23/98	1000	$26.13	
		2000		($17,125.00)
Walsh, Richard W.	06/29/98	850	$22.875	
Walsh, Richard W.	07/02/98	100	$20.250	
Walsh, Richard W.	07/08/98	350	$19.500	
Walsh, Richard W.	07/10/98	95	$21.250	
		1395		($20,441.48)
Zaretsky, Robert	04/21/98	1000	$22.25	
Zaretsky, Robert	04/21/98	1000	$22.69	
Zaretsky, Robert	04/23/98	1000	$22.75	
Zaretsky, Robert	06/03/98	1000	$16.88	
		4000		($27,723.00)

Totals=		**66,795**		**($232,653.58)**

DECLARATION OF SERVICE BY MAIL

I, the undersigned, declare:

1. That declarant is and was, at all times herein mentioned, a citizen of the United States and a resident of the County of San Diego, over the age of 18 years, and not a party to or interest in the within action; that declarants business address is 401 B Street, Suite 1700, San Diego, California 92101.

2. That on May 16, 2002, declarant served the THIRD AMENDED CLASS ACTION COMPLAINT FOR VIOLATION OF THE FEDERAL SECURITIES LAWS by depositing a true copy thereof in a United States mailbox at San Diego, California in a sealed envelope with postage thereon fully prepaid and addressed to the parties listed on the attached Service List.

3. That there is a regular communication by mail between the place of mailing and the places so addressed.

I declare under penalty of perjury that the foregoing is true and correct. Executed this 16th day of May, 2002, at San Diego, California.

/s/ Christine Nagy
CHRISTINE NAGY

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Lead Counsel for Plaintiffs

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF CALIFORNIA

In re DAOU SYSTEMS, INC. SECURITIES LITIGATION	Master File No. 98cv1537-L(CGA)
This Document Relates To: ALL ACTIONS.	CLASS ACTION NOTICE OF APPEAL AND NINTH CIRCUIT RULE 3-2 REPRESENTATION STATEMENT

(Filed Nov. 13, 2002)

NOTICE IS HEREBY GIVEN that lead plaintiffs in the above-named case, Greg Sparling, Eugene Krabbenhoft, Patrick de Kruyff, Robert Zaretsky, Rod Ford, Thomas V. Hagman, Richard W. Walsh, Richard Toribio, and Paul Rabin, on behalf of themselves and all others similarly situated, hereby appeal to the United States Court of Appeals for the Ninth Circuit from the judgment entered on October 16, 2002, and "Order Granting Defendants' Motion to Dismiss Consolidated Third Amended Class

Action Complaint" entered on October 16, 2002, and all prior interlocutory orders, including but not limited to, the Order Granting Without Prejudice Defendants' Motion to Dismiss Consolidated Second Amended Class Action Complaint entered on March 28, 2002.

DATED: November 13, 2002

Respectfully submitted,

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RULE 3-2 REPRESENTATION STATEMENT

Plaintiffs in this action, Greg Sparling, Eugene Krabbenhoft, Patrick de Kruyff, Robert Zaretsky, Rod Ford, Thomas V. Hagman, Richard W. Walsh, Richard Toribio, and Paul Rabin, on behalf of themselves and all others similarly situated, are represented by the following counsel:

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Several defendants in this action, Georges Daou, Daniel Daou, Fred McGee, Robert McNeill, and John Moragne, are represented by:

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DATED: November 13, 2002

Respectfully submitted,

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DECLARATION OF SERVICE BY MAIL

I, the undersigned, declare:

1. That declarant is and was, at all times herein mentioned, a citizen of the United States and a resident of the County of San Diego, over the age of 18 years, and not a party to or interest in the within action; that declarants business address is 401 B Street, Suite 1700, San Diego, California 92101.

2. That on November 13, 2002, declarant served the **NOTICE OF APPEAL AND NINTH CIRCUIT RULE 3-2 REPRESENTATION STATEMENT** by depositing a true copy thereof in a United States mailbox at San Diego, California in a sealed envelope with postage thereon fully prepaid and addressed to the parties listed on the attached Service List.

3. That there is a regular communication by mail between the place of mailing and the places so addressed.

I declare under penalty of perjury that the foregoing is true and correct. Executed this 13th day of November, 2002, at San Diego, California.

/s/ Tamara Thweatt
Tamara Thweatt

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UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF CALIFORNIA

In re DAOU SYSTEMS, INC. SECURITIES LITIGATION	Master File No. 98-CV-1537-L (CGA)
This Document Relates To: ALL ACTIONS.	**CLASS ACTION** **NOTICE OF CROSS-APPEAL AND NINTH CIRCUIT RULE 3-2 REPRESENTATION STATEMENT**

(Filed Nov. 26, 2002)

NOTICE IS HEREBY GIVEN that Defendant DAOU SYSTEMS, INC. in the above-named case hereby appeals to the United States Court of Appeals for the Ninth Circuit from the judgment entered on October 16, 2002, and Order Granting Defendants' Motion to Dismiss Consolidated Third Amended Class Action Complaint filed on October 16, 2002.

Dated: November 26, 2002 GORDON & REES LLP

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Counsel for Defendant
DAOU SYSTEMS, INC.

RULE 3-2 REPRESENTATION STATEMENT

Defendant in this action, DAOU SYSTEMS, INC., on behalf of itself and all others similarly situated, are represented by the following counsel:

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Dated: November 26, 2002

Respectfully submitted,

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DECLARATION OF SERVICE BY MAIL

I, the undersigned, declare:

1. That declarant is and was, at all times herein mentioned, a citizen of the United States and a resident of the County of San Diego, over the age of 18 years, and not a party tc or interest in the within action; that declarant's business address is 101 West Broadway, Suite 1600, San Diego, CA 92101.

2. That on November 26, 2002, declarant served the NOTICE OF CROSS-APPEAL AND NINTH CIRCUIT RULE 3-2 REPRESENTATION STATEMENT by depositing a true copy thereof in a United States mailbox at San Diego, California in a sealed envelope with postage thereon fully prepaid and addressed to the parties listed on the attached Service List.

3. That there is a regular communication by mail between the place of mailing and the places so addressed.

I declare under penalty of perjury that the foregoing is true and correct. Executed this 27th day of November, 2002, at San Diego, California.

/s/ Jackie Finn
Jackie Finn

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[Attachments Omitted In Printing]

(2)

No. 05-700

Supreme Court, U.S.
FILED
JAN 3 - 2005
OFFICE OF THE CLERK

IN THE

Supreme Court of the United States

DAOU SYSTEMS, INC., GEORGES DAOU, DANIEL DAOU, FRED MCGEE, ROBERT MCNEILL and JOHN MORAGNE,
Petitioners,

v.

GREG SPARLING, EUGENE KRABBENHOFT, PATRICK DE KRUYFF, ROBERT ZARETSKY, ROD FORD, THOMAS V. HAGMAN, RICHARD W. WALSH, RICHARD TORIBIO and PAUL RABIN, On Behalf of Themselves and All Others Similarly Situated,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

WILLIAM S. LERACH
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QUESTIONS PRESENTED

1. Whether a securities-fraud plaintiff, who contends a securities issuer falsified its financial results by recognizing revenue before it was earned, may plead loss causation by alleging the stock's price dropped significantly as the issuer's true financial condition became known to the market.

2. Whether a securities-fraud plaintiff can adequately state a claim based in part on information from confidential sources.

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IN THE

Supreme Court of the United States

No. 05-700

DAOU SYSTEMS, INC., GEORGES DAOU, DANIEL DAOU, FRED MCGEE, ROBERT MCNEILL and JOHN MORAGNE,
Petitioners,

v.

GREG SPARLING, EUGENE KRABBENHOFT, PATRICK DE KRUYFF, ROBERT ZARETSKY, ROD FORD, THOMAS V. HAGMAN, RICHARD W. WALSH, RICHARD TORIBIO and PAUL RABIN, On Behalf of Themselves and All Others Similarly Situated,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

INTRODUCTION

The petition for a writ of certiorari should be denied.

Although petitioners charge the Ninth Circuit with refusing to apply this Court's opinion in *Dura Pharm., Inc. v. Broudo*, __ U.S. __, 125 S.Ct. 1627 (2005), the record demonstrates quite the opposite. After initially deciding this appeal, the Ninth Circuit *sua sponte* stayed its mandate by deferring consideration of petitioners' rehearing petition pending the issuance of this Court's opinion in *Dura*. And when the

decision in *Dura* came down, the Ninth Circuit ordered supplemental briefing on the significance of this Court's decision, and then issued an amended opinion applying this Court's decision. The Ninth Circuit holds that when defendants are alleged to have created, by recognizing revenues that were not earned, a false picture of a company's financial health, investors who purchase its stock at an inflated price suffer a compensable loss when the price collapses on disclosure of the true state of the company's finances. Nothing in this holding conflicts with this Court's decision in *Dura*. *See infra* 2-5.

Petitioners contend this Court's review is warranted for the further reason that the circuits are in conflict concerning whether plaintiffs in securities cases must reveal *in their complaints* confidential sources for their factual allegations. The circuits, however, are in agreement that plaintiffs need not provide more detailed information than was provided in this case. *See infra* 5-7.

The petition for a writ of certiorari should accordingly be denied.

REASONS FOR DENYING THE PETITION

A. The Ninth Circuit Faithfully Applied *Dura*

Although petitioners say the Ninth Circuit has, in this case, displayed "apparent intransigence to apply this Court's holding in *Dura*," Pet. 7, and that it has "rendered this Court's decision in Dura a legal nullity," Pet. 14, the record demonstrates quite the opposite. In truth the panel below took great care to conform its decision to *Dura*.

The Ninth Circuit panel initially decided the case with an opinion issued on February 2, 2005, and published as *In re Daou Sys.*, 397 F.3d 704 (9th Cir. 2005). *See* App. 43-82. Notably, that opinion's analysis of loss causation steered clear of the Ninth Circuit's analysis in some other cases, which had held that loss was suffered at the time of

purchasing a security at an inflated price, with nothing more. Rather, the court below focused on the collapse in Daou's stock price that occurred as the true state of its finances became known. *See* App. 73-74. Noting the district court had held that if Daou's "improper accounting did not lead to [a] decrease in Daou's stock price, plaintiffs' reliance on the improper accounting in acquiring the stock would not be sufficiently linked to their damages," the Ninth Circuit held that plaintiffs had indeed alleged a collapse in stock price causally related to fraud. *Id.* It explained:

> An independent assessment of the TAC, however, indicates that the price of the stock fell precipitously after defendants revealed figures vastly different than those reported in a press conference two weeks prior. The complaint also anonymously quotes an analyst who allegedly stated, "[w]hen you say one thing on the conference call and report something different on the 10-Q, that raises concern. . . . *You have got to question whether they are manufacturing earnings.*"

App. 74. Taken as a whole, the Ninth Circuit concluded, the complaint was "sufficient to show that the drop in Daou's stock price was the direct result of [petitioners'] financial misstatements and, in turn caused plaintiffs' damages." *Id.*

When petitioners sought rehearing, the panel *sua sponte* deferred consideration of the petition for rehearing pending this Court's decision of *Dura,* so that it could ensure absolute conformity with this Court's ruling in that case. Supp. App. 1sa. When *Dura* was decided, moreover, the Ninth Circuit ordered supplemental briefing on the significance of this Court's opinion. Supp. App. 2sa.

Dura held that plaintiffs alleging securities fraud cannot rely exclusively on allegations that they purchased stock at an inflated price, but must also relate the fraud to a decline in price or other economic loss. In *Dura,* this Court noted that the complaint's "failure to claim that Dura's share price fell

significantly after the truth became known suggests that the plaintiffs considered the allegation of purchase price inflation alone sufficient." *Dura*, 125 S. Ct. at 1634. The complaint in this case, of course, suffered no similar deficiency, as a dramatic decline in price on disclosure of the truth was clearly alleged—as the Ninth Circuit had itself noted in its February 2 opinion. *See* App. 74.

Nonetheless, the Ninth Circuit withdrew its initial opinion, replacing it with an amended opinion, published as *In re Daou Sys.*, 411 F.3d 1006 (9th Cir. 2005), that expressly—and faithfully—applies this Court's decision in *Dura*. App. 30-35. The new opinion explains in detail that plaintiffs in this case suffered a loss that was causally related to the financial fraud alleged, when Daou's stock price dropped as the truth became apparent. *Id.* Its holding is completely faithful to this Court's holding in *Dura*:

> Plaintiffs' economic loss was not that they purchased stock at inflated prices; rather, their economic loss was the decline in their stock value that was the direct result of Daou's misrepresentations. *See Dura Pharms.*, 125 S.Ct. at 1631-32. Here, the TAC's assertions of a steep drop in Daou's stock price following the revelation of Daou's true financial situation are sufficient to enable the complaint to survive a motion to dismiss under Federal Rule of Civil Procedure 12(b)(6).

App. 34-35.

The Ninth Circuit holds, moreover, that because the operative complaint, as currently drafted, "does not allege any revelation of Daou's true financial health prior to August 1998," under *Dura* "any loss suffered [before that date] cannot be considered causally related to Daou's allegedly fraudulent accounting methods because before the revelations began in August 1998, the true nature of Daou's financial condition had not yet been disclosed." App. 34.

This is by no means a record that displays "apparent intransigence to apply this Court's holding in *Dura*," as

petitioners would have it. Pet. 7. The Ninth Circuit faithfully applies *Dura*. The petition for certiorari should be denied.

B. The Case Presents No Conflict Among the Circuits on Pleading Sources

Petitioners say that the circuits are in conflict on when and how investors might plead a case involving confidential sources. In truth, the circuits line up in remarkable concord, and whatever "conflict" there might be is immaterial to the result in this case.

The leading decision is *Novak v. Kasaks*, 216 F.3d 300 (2d Cir. 2000), which other circuits have expressly followed. Acknowledging *ABC Arbitrage v. Tchuruk*, 291 F.3d 336, 351-53 (5th Cir. 2002), for example, petitioners must concede: "The Fifth Circuit has adopted the Second Circuit's holding in *Novak*." Pet. 22. So did the First Circuit, in *In re Cabletron Sys.*, 311 F.3d 11, 28 (1st Cir. 2002), which embraced the standard "drawn from the Second Circuit's *Novak* decision." *Id.* "The approach we take, similar to *Novak*," it said "is to look at all of the facts alleged to see if they 'provide an adequate basis for believing that the defendants' statements were false.'" *Id.* at 29 (quoting *Novak*, 216 F.3d at 314). The Third Circuit reached precisely the same conclusion, similarly following *Novak*: "We join the Second Circuit and adopt this standard as the appropriate standard for courts to employ when assessing the sufficiency of allegations made on information and belief pursuant to 15 U.S.C. §78u-4(b)(1)." *CALPERS v. Chubb Corp.*, 394 F.3d 126, 146 (3d Cir. 2004). "The *Novak* approach to assessing the particularity of allegations made on information and belief necessarily entails an examination of the detail provided by the confidential sources, the sources' basis of knowledge, the reliability of the sources, the corroborative nature of other facts alleged, including from other sources, the coherence and plausibility of the allegations, and similar indicia." *Id.* at 147.

The Ninth Circuit has repeatedly endorsed the very same approach, first in *Nursing Home Pension Fund, Local 144 v. Oracle Corp.*, 380 F.3d 1226, 1233-34 (9th Cir. 2004), and now in this case. In *Oracle*, the Ninth Circuit joined the Second, Third, and Fifth Circuits in holding "that personal sources of information relied upon in a complaint should be 'described in the complaint with sufficient particularity to support the probability that a person in the position occupied by the source would possess the information alleged.'" *Id.* at 1233 (quoting *Novak*, 216 F.3d at 314).

"In this case," too, petitioners must concede, "the Ninth Circuit expressly adopted the approach of the courts in *Novak* and *Cabletron*." Pet. 23. Their only objection is that "in applying the *Cabletron* factors, the court did not analyze the reliability of the confidential sources" in precisely the way that petitioners urged. *Id.* Yet this is no basis for issuing a writ of certiorari. "A petition for a writ of certiorari is rarely granted when the asserted error consists of erroneous factual findings or the misapplication of a properly stated rule of law." Supreme Court Rule 10.

Petitioners try to gin up a conflict among the circuits, nonetheless, by contending that the Eighth Circuit, in *Florida State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645 (8th Cir. 2001), somehow deviates from the *Novak* approach followed by the Second, Third, and Fifth Circuits. In fact, the Eighth Circuit cites *Novak* as a decision that "sensibly refused" to adopt a more demanding pleading standard. *Id.* at 668. There is no meaningful conflict here.

Petitioners are left to argue that the Tenth Circuit has required *something less* of securities-fraud plaintiffs than is demanded by the other circuits, and by the Ninth Circuit in this case. "In *Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083 (10th Cir. 2003)," they say, "the Tenth Circuit held that confidential sources were acceptable and that the holding in *Novak* requiring either identification of sufficient docu-

mentary support or a sufficiently particularized description of the confidential sources was too restrictive, and not required by the PSLRA." Pet. 26. If this identifies a genuine conflict, however, it is of no help to petitioners—for the complaint in this case obviously would survive under a *more lenient* standard than that applied to it. Resolving the purported "conflict" could have no impact on the result in this case.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied. This simply is not a case where "a United States court of appeals has entered a decision in conflict with the decision of another United States court of appeals on the same important matter; has decided an important federal question in a way that conflicts with a decision by a state court of last resort; or has so far departed from the accepted and usual course of judicial proceedings, or sanctioned such a departure by a lower court, as to call for an exercise of this Court's supervisory power." Supreme Court Rule 10(a).

Respectfuly submitted,

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APPENDIX

SUPPLEMENTAL APPENDIX

NOT FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 02-56989
D.C. No. CV-98-01537-L/CGA
Southern District of California, San Diego

In re: DAOU SYSTEMS, INC., SECURITIES LITIGATION,

GREG SPARLING; EUGENE KRABBENHOFT; PATRICK DE KRUYFF, ESQ.; ROBERT ZARETSKY; ROD FORD; THOMAS V. HAGMAN; RICHARD W. WALSH; RICHARD TORIBIO; PAUL RABIN,

Plaintiff-Appellants,

v.

GEORGES DAOU; DANIEL DAOU; FRED MCGEE; ROBERT MCNEILL; JOHN MORAGNE; DAOU SYSTEMS, INC.,

Defendants-Appellees.

ORDER

(filed March 3, 2005)

Before: B. FLETCHER, PREGERSON, and BRUNETTI, *Circuit Judges*.

Consideration of the petition for panel rehearing filed by Daou Systems Inc., et al., is deferred pending the Supreme Court's decision in *Dura Pharmaceuticals. Inc. v. Broudo*. Supreme Court Docket No. 03-932.

NOT FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 02-56989
D.C. No. CV-98-01537-L/CGA
Southern District of California, San Diego

In re: DAOU SYSTEMS, INC., SECURITIES LITIGATION,

GREG SPARLING; EUGENE KRABBENHOFT; PATRICK DE KRUYFF, ESQ.; ROBERT ZARETSKY; ROD FORD; THOMAS V. HAGMAN; RICHARD W. WALSH; RICHARD TORIBIO; PAUL RABIN,

Plaintiff-Appellants,

v.

GEORGES DAOU; DANIEL DAOU; FRED MCGEE; ROBERT MCNEILL; JOHN MORAGNE; DAOU SYSTEMS, INC.,

Defendants-Appellees.

ORDER

(filed April 20, 2005)

Before: B. FLETCHER, PREGERSON, and BRUNETTI, *Circuit Judges.*

The parties are directed to file, within 21 days of this order, simultaneous briefs not to exceed fifteen (15) pages addressing the impact of the Supreme Court's decision in *Dura Pharmaceuticals, Inc. v. Broudo,* 544 U.S. (2005), on the opinion in this case.

Supreme Court, U.S.
FILED
JAN 12 2006
OFFICE OF THE CLERK

No. 05-700

IN THE

Supreme Court of the United States

DAOU SYSTEMS, INC., GEORGES DAOU, DANIEL DAOU, FRED MCGEE, ROBERT MCNEILL AND JOHN MORAGNE,

Petitioners,

v.

GREG SPARLING, EUGENE KRABBENHOFT, PATRICK DE KRUYFF, ROBERT ZARETSKY, ROD FORD, THOMAS V. HAGMAN, RICHARD W. WALSH, RICHARD TORIBIO AND PAUL RABIN, ON BEHALF OF THEMSELVES AND ALL OTHERS SIMILARLY SITUATED,

Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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CORPORATE DISCLOSURE STATEMENT

On October 28, 2005, Daou Systems, Inc. merged with PRX Acquisitions Sub, Inc. to form Proxicom-Daou, Inc. Proxicom-Daou, Inc. is wholly owned by Proxicom, Inc. There is no publicly held corporation that owns 10% or more of stock in Proxicom, Inc.

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Lyle Roberts & Paul Chalmers, *Shining a Light or Cursing the Darkness?—The Impact of Dura Pharms., Inc. v. Broudo*, in SECURITIES LITIGATION ENFORCEMENT INSTITUTE 2005 (PLI CORP. LAW & PRACTICE, COURSE HANDBOOK SERIES NO. 1505, 2005) 2

No. 05-700

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Petitioners,

v.

GREG SPARLING, EUGENE KRABBENHOFT, PATRICK DE KRUYFF, ROBERT ZARETSKY, ROD FORD, THOMAS V. HAGMAN, RICHARD W. WALSH, RICHARD TORIBIO AND PAUL RABIN, ON BEHALF OF THEMSELVES AND ALL OTHERS SIMILARLY SITUATED,

Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

REPLY BRIEF FOR THE PETITIONERS

I. THE NINTH CIRCUIT OPINION HERE, IN THE IMMEDIATE WAKE OF THIS COURT'S DECISION IN *DURA*, UNDULY LIMITS THE HOLDING IN *DURA*.

The opposition to the petition for a writ of certiorari is most significant for what it does not address—*that the Ninth Circuit's opinion below diverges, significantly, from the decisions of other courts that have considered this Court's decision in Dura Pharmaceuticals, Inc.* v. *Broudo*, 125 S.Ct. 1627 (2005). *See* Pet. 11-14. Respondents simply ignore this conflict that is obvious to others. Indeed, comparing the

Ninth Circuit's decision here with the Sixth Circuit's decision in *D.E. & J. Limited Partnership* v. *Conaway*, Nos. 03-2334, 03-2417, 2005 WL 1386448 (6th Cir. Jun. 10, 2005), a recent Practising Law Institute article commented "[i]t is difficult to reconcile the holdings of the two appellate courts, which appear to have different concepts of what constitutes a disclosure of the 'relevant truth.'" Lyle Roberts & Paul Chalmers, *Shining a Light or Cursing the Darkness?—The Impact of Dura Pharms., Inc. v. Broudo*, in SEC. LITIG. ENFORCEMENT INST. 2005, at 343, 352 (PLI CORP. LAW & PRACTICE, COURSE HANDBOOK SERIES NO. 1505, 2005); *see also* Pet. 11 n.5 (citing other authority recognizing a post-*Dura* conflict).

In fact, a number of other courts of appeals and district courts that have considered the loss causation requirement, both pre- and post-*Dura*, are true to *Dura*'s holding: in order to plead loss causation, a plaintiff must causally link a drop in the stock price to a time at which an alleged fraudulent misrepresentation was discovered and the truth became known. *See* Pet. 11-14. By contrast, respondents contend that *Dura* is satisfied by an allegation that the stock price decreased, and that a plaintiff need not link that decrease to any point in time when the truth became known.

These are vastly different readings of the loss causation requirement and of this Court's decision in *Dura*. The literal language of this Court's decision in *Dura* found the complaint insufficient because it contained no allegation that there was a point in time when "the share price fell significantly after the truth became known." *Dura*, 125 S. Ct. at 1634. The cases cited in *Dura* rejected a holding that the issuance of a negative earnings report is sufficient to establish a moment when the truth became known. *See id.* at 1633 (citing cases); Pet. 9-12. This Court also justified its decision in *Dura* in part on the fact that there are manifold reasons why stock prices rise and fall. *See Dura*, 125 S. Ct.

at 1632. All of the above supports rejection of the Ninth Circuit's view of the loss causation requirement.

In the past, this Court has repeatedly granted certiorari to review court of appeals decisions that would have otherwise undone Congress's work in passing the Private Securities Litigation Reform Act of 1995 ("PSLRA"), Pub. L. No. 104-67, 109 Stat. 737. It should do so again here, particularly because the Ninth Circuit's decision threatens to undo much of what this Court accomplished in *Dura*. That is because the Ninth Circuit's interpretation of this Court's opinion in *Dura* more closely follows the Ninth Circuit's own *Dura* opinion, than this Court's opinion reversing it.

II. THE PRACTICE OF PLEADING THE FACTS OF A SECURITIES FRAUD CLASS ACTION USING "CONFIDENTIAL WITNESSES" MERITS REVIEW BY THIS COURT.

The second issue presented in the petition also merits review—the use of "confidential witnesses" in private securities fraud class actions in order to plead allegations relating to scienter, or allegations of misrepresentations or omissions made on information and belief." There is no mystery what is going on here. For many years, plaintiffs in securities fraud class action suits would plead the entire complaint "on information and belief." The holdings of several federal courts, as well as Congress's passage of the PSLRA, put a stop to this practice. Such facts must now be pled with particularity. *See* 15 U.S.C. § 78u-4(b)(1) and (2). Plaintiffs' counsel, however, have simply changed tactics by claiming that much, if not all, of their factual allegations come from "confidential witnesses."

While the protection of confidential witnesses may have a place in criminal law, it is hard to justify a similar role in civil action under the PSLRA. The identity of witnesses cannot be protected any longer than the first wave of written discovery. Therefore, the use of confidential witnesses could

serve no purpose other than to allow plaintiffs to survive the pleadings stage and reach the first wave of discovery, in the hopes of discovering facts that will allow the complaint to survive long enough to negotiate a lucrative settlement. Yet, that goal is entirely contrary to Congress's key goal in adopting the PSLRA, which is to impose a rigid gatekeeping function on securities fraud class action complaints at the pleadings stage. *See generally Dura*, 125 S. Ct. at 1634 (citing H.R. Rep. No. 104-369 at 31 (1995) (Conf. Rep.)).

This Court has never ruled on the propriety of using confidential witness allegations as a means of satisfying the PSLRA. Many district courts have held that the practice is not permitted. *See* Pet. 27-28. As is plain from the petition and the opposition, the practice will continue unless and until this Court brings it to a halt, and petitioners urge this Court to do so.

However, even if this Court concludes that the use of confidential witnesses to support certain allegations in a securities fraud class action is not *per se* impermissible under the PSLRA, one fact remains clear—there is a significant difference in the standards courts of appeals have applied to determine the sufficiency of allegations by confidential witnesses. *See* Pet. 19-26. Commentators have noted that the Ninth Circuit's approach below is more lenient. *See* Pet. 23 (citing authority). And, as exemplified by the different approaches followed by the district court and the Ninth Circuit in this case, the standard that is applied is determinative of whether a complaint is deemed sufficient under the stringent pleading requirements of the PSLRA, or whether it is dismissed. If allegations under the PSLRA may be based on confidential witness statements at all, this Court should clarify that there are strict limits on a complaint's reliance on such statements. This should include a rejection of the Ninth Circuit's lenient standard and the adoption of a requirement of close scrutiny of the allegations to establish the potential reliability of such witnesses.

CONCLUSION

For the foregoing reasons and those stated in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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